
PERFORMANCE AUDIT OF THE CITY'S MAJOR BUILDING ACQUISITION PROCESS

Finding 1: The prior City Administration did not follow best practices when acquiring more than \$230 million of major real estate assets due to unclear roles and responsibilities, resulting in significantly increased costs and underutilized facilities.

Finding 2: The prior City Administration failed to conduct sufficient due diligence, limiting the City's understanding of the properties acquired and hindering its ability to negotiate.

Finding 3: The prior City Administration diminished City Council's oversight capabilities on major real estate acquisitions by failing to provide complete and accurate information.

Office of the
City Auditor

City of San Diego



Performance Audit of the City's Major Building Acquisition Process

Why OCA Did This Study

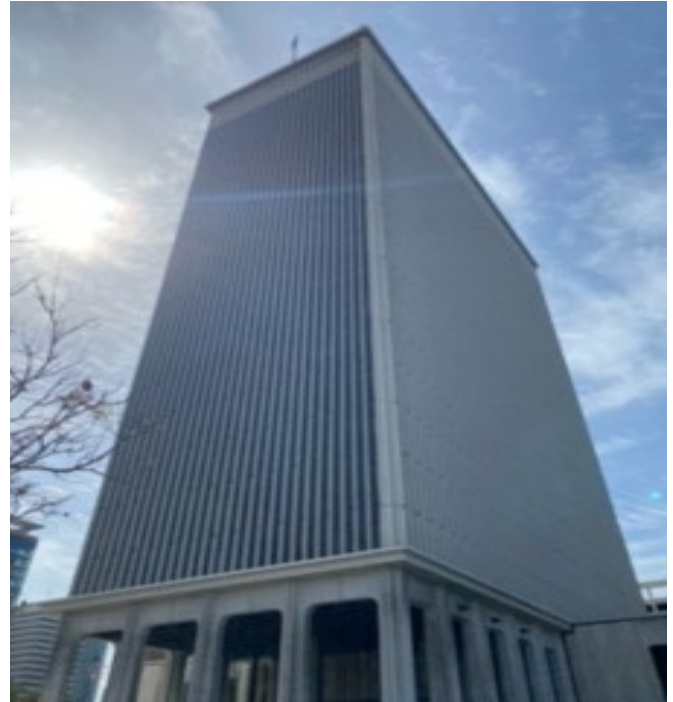
In 2015, the City began a series of building acquisitions totaling more than \$230 million. Many questions have been raised about whether these acquisitions were in the best interest of the City. We conducted this audit to determine (1) if the City followed policies and best practices when acquiring major buildings, and (2) if the City has sufficient governance mechanisms for oversight of major building acquisitions.

What OCA Found

Overall, we found that a serious lack of policies and oversight caused the City to miss or skip key steps in the acquisition process, and allowed the prior City Administration to leave out or misrepresent key information about building acquisitions when presenting them to the City Council and the public.

Finding 1: The prior City Administration failed to follow real estate best practices due to unclear roles and responsibilities, resulting in costs eclipsing estimates presented to City Council, buildings being underutilized, and the City making major investments in buildings that it did not understand the condition of.

- Key elements of due diligence were not completed because the Real Estate Assets Department (READ) believed acquiring departments were responsible for gathering this information. However, acquiring departments believed due diligence was READ's responsibility.
- The City Attorney's Office did not consistently document and present to City Council the legal risks of the contracts to acquire the buildings—for example, the 101 Ash contract placed the responsibility on the City to understand the building's condition and limited the City's options if it discovered issues with 101 Ash later.
- The former Mayor's Office used an uncontracted advisor that had significant influence over the 101 Ash and Civic Center Plaza acquisitions. Without having a contract and obtaining the advisor's economic disclosures, the City did not ensure the advisor's loyalty. We now know the seller paid the City's advisor \$9.4 million on these two transactions.
- The City does not have a clear decisionmaker within the administration for leading acquisition decisions, beyond the Mayor. Without a lead party making decisions at the day-to-day level, responsibilities may fall through the cracks.



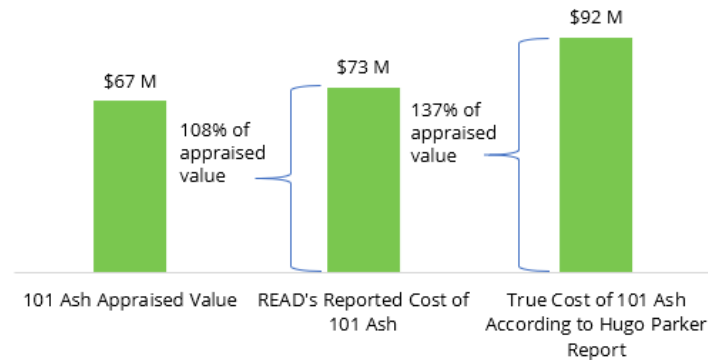
101 Ash Street Building. Source: OCA, 2021

- Economic analyses on the costs and benefits of acquiring the buildings did not include significant information, including the costs of the lease-to-own funding structure or accurate costs of tenant improvements.
- The City addresses real estate needs as situations arise, without a central strategic plan and without requiring the establishment of a clear business case for purchasing a building.

Finding 2: The prior City Administration failed to conduct sufficient due diligence on the major building acquisitions in our scope, limiting the City's knowledge of the properties and hindering its ability to negotiate.

- READ often did not obtain independent appraisals of the properties acquired or use the appraised value in negotiations, potentially resulting in the City paying more for the buildings in several cases.
- READ did not consistently gather building condition assessments, which can help negotiations or anticipate improvement costs post acquisition.
- The City did not conduct asbestos inspections on any of the buildings prior to acquisition, as required by City Policy.
- The City does not consistently conduct test fits on buildings prior to acquisition, which can lead to unforeseen and expensive renovation costs after the building is acquired.

READ Did Not Clearly Report the True Cost to Acquire 101 Ash



Source: OCA generated based on appraisal for 101 Ash, staff reports on 101 Ash, and Hugo Parker report.

Finding 3: The prior City Administration did not inform City Council and the public of all material facts on 101 Ash and the Housing Navigation Center, limiting the City Council's ability to perform its oversight role.

- READ misrepresented the condition of 101 Ash—staff told City Council that the building was Class A, in excellent condition, and only in need of \$10,000 of repairs when the building was classified as Class B and the City did not conduct its own assessment to ensure the building did not need more repairs. In 2020, after investing \$26 million in tenant improvements, City contractors estimated 101 Ash needs \$115 million in improvements and repairs.
- READ did not disclose that it did not perform its own due diligence of 101 Ash—it accepted all the seller's documents.
- READ did not clearly state the cost to purchase 101 Ash. The purchase price was \$92 million, not \$72.5 million as reported to City Council.
- The prior City Administration did not clarify the reasons why it was not proposing to purchase 101 Ash directly—which would have reportedly saved the City \$17.2 million.
- For the Housing Navigation Center, READ relied on the seller's appraisal of the building as an indoor skydiving facility—significantly inflating its value to City Council.
- Although City staff did not provide all material facts to City Council as required by the City Charter, the City does not have an enforcement mechanism in the municipal code to take action against employees who mislead City Council.
- The prior City Administration's lack of planning and rushed timelines on several deals minimized the time City Council had to evaluate major building acquisitions.

What OCA Recommends

We made 10 recommendations to help ensure the City follows best practices when acquiring major buildings and informs the City Council and the public of all material facts. Key recommendations include:

- Requiring a best practices checklist for building acquisitions. The checklist would ensure each acquisition fits into the strategic plan and has a determination of what it will be used for, funding method analysis, more accurate tenant improvement costs estimates, and written analysis flagging significant legal risks.
- Establishing clear roles and responsibilities for City departments involved in the acquisition process.
- Developing and using a strategic real estate plan for future office space usage.
- Requiring all contractors or advisors on real estate transactions have a signed contract with the City.
- Requiring READ to create a due diligence checklist to ensure the City gets independent appraisals, independent building condition assessments, environmental assessments, independent asbestos assessments, and test fits. These reports should be included in the materials that are provided to the City Council and the public prior to acquisition approval.
- Adding a section to the municipal code to provide an enforcement mechanism to ensure City staff accurately represent information to City Council.
- Providing the Office of the Independent Budget Analyst with sufficient time, information, and resources to thoroughly review the Mayor's major building acquisition proposals.

Implementing these recommendations will increase the time it takes the City to execute major building acquisitions and could foreseeably result in the City missing out on a good investment from time to time. However, our review of the City's history in this area clearly indicates that this risk is far outweighed by the alternative—major building acquisition failures that cost taxpayers millions of dollars, disrupt City operations, and seriously damage the City's reputation in the eyes of the public.

The City Administration did not agree to fully implement the majority of our recommendations.

For more information, contact Andy Hanau, City Auditor at (619) 533-3165 or cityauditor@sandiego.gov.



THE CITY OF SAN DIEGO

July 22, 2021

Honorable Mayor, City Council, and Audit Committee Members
City of San Diego, California

Transmitted herewith is a performance audit report of the City's Major Building Acquisition Process. This report was conducted in accordance with the City Auditor's Fiscal Year 2021 Audit Work Plan, and the report is presented in accordance with City Charter Section 39.2. Audit Objectives, Scope, and Methodology are presented in Appendix G. Management's response to our audit recommendations starts on page 90; our comments on Management's response start on page 97. The City Attorney's Office's response to our audit recommendations starts on page 100; our comments on the City Attorney's Office's response start on page 107. The Independent Budget Analyst's Office's response to our recommendations starts on page 111.

We would like to thank staff from the Department of Real Estate Assets and Airport Management, Department of Finance, Debt Management, Office of the Independent Budget Analyst, Office of the City Attorney, and all the other departments and former City staff that assisted with this audit. All of their valuable time and efforts spent on providing us information is greatly appreciated. The audit staff members responsible for this audit report are Carissa Nash, Megan Jaffery, Danielle Novokolsky, Danielle Knighten, and Kyle Elser.

Respectfully submitted,

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Background

In 2015, the City of San Diego (City) began a series of building acquisitions totaling more than \$230 million. In the years following, many questions have been raised about whether these acquisitions were in the best interest of the City. Therefore, in accordance with the Office of the City Auditor's Fiscal Year (FY) 2021 Audit Work Plan, we conducted a performance audit of the City's Real Estate Assets Department's (READ) asset acquisition process. The two objectives for this performance audit are as follows:

1. To determine if the City followed policies and best practices when purchasing buildings or entering into lease agreements worth more than \$5 million from FY2015 to FY2019; and
2. To determine if the City has sufficient governance mechanisms for oversight of purchases and lease agreements worth more than \$5 million from FY2015 to FY2019.

Scope Real estate terminology tends to define real estate asset acquisitions as direct purchases. However, because our scope includes review of buildings the City obtained via direct purchase, lease, and lease-to-own, we use the term *acquisition* to refer to all three methods.

Our review focused on the acquisition process at the City for the select buildings in our scope up until the point of acquisition; it did not include a review of the aftermath of these acquisitions. Therefore, our analysis does not include decisions on tenant improvements, contractors selected for renovations, and asbestos abatements. However, as discussed in the report, shortcomings in the acquisition process can increase the risks and costs associated with buildings after they are purchased.

We found the City agreed to spend more than \$230 million to acquire five buildings. The \$230 million investment includes the purchase price and the total lease payments the City agreed to,

which include financing costs. Below, we provide a brief description of the buildings included in our scope.

Civic Center Plaza - Acquired in March 2015

Exhibit 1

Civic Center Plaza



Source: OCA, April 2021

The City leased-to-own the Civic Center Plaza building and King Chavez High School facility to provide office space for City employees, who had been housed in the Civic Center Plaza building since 1991.¹ The City began leasing-to-own the buildings in March 2015 for \$270,000 per month, increasing by 2.5 percent per year for 20 years (\$82.8 million total). See **Appendix B** for details on our findings related to this transaction.

¹ The Civic Center Plaza building and King Chavez High School facility are on one plot of land. In this report we discuss them together as Civic Center Plaza.

101 Ash Street Building – Acquired in January 2017

Exhibit 2

101 Ash Street Building



Source: OCA, April 2021

The City leased-to-own the 101 Ash Street building to provide office space for employees housed in the City Operations Building, which is not in good condition, and to provide the public with a better Development Services Department facility. The City began leasing-to-own the building in January 2017 for \$534,726 per month for 20 years (approximately \$128 million total). See **Appendix A** for details on our findings related to this transaction.

Kearny Mesa Repair Facility – Acquired in May 2017

Exhibit 3

Kearny Mesa Repair Facility



Source: San Diego Union Tribune, May 2020

The City began leasing the former Hawthorne Machinery facility on Othello Avenue to use as a space to repair Fire-Rescue apparatuses (fire trucks). A consultant found that the City's Miramar Repair facility did not have enough space to repair both fire trucks and refuse packers (trash trucks). The limited space at the Miramar Repair Facility meant staff could not repair trucks as quickly, meaning more trucks were out of commission longer and the City had to purchase additional trucks. The City entered into a 10-year lease with two 5-year options to extend the lease in May 2017. The City extended the lease to a 15-year lease with three 5-year options in September 2019. The City will make approximately \$14.1 million in base lease payments over the first 15 years of the lease. See **Appendix D** for details on our findings related to this transaction.

Palm Avenue Hotel – Acquired in August 2017

Exhibit 4

Palm Avenue Hotel



Source: OCA, March 2021

The City purchased the former Super 8 Hotel on Palm Avenue to use as transitional housing for participants in the San Diego Misdemeanants At-Risk Track (S.M.A.R.T.) Program. The goal of the program is to divert individuals from receiving repeat misdemeanor violations for drug-related offenses. The participants are mostly people experiencing homelessness. The City purchased the hotel using Community Development Block Grant funds from the United States Department of Housing and Urban Development for \$6.65 million in August 2017. See **Appendix E** for details on our findings related to this transaction.

Housing Navigation Center – Acquired in January 2018

Exhibit 5

Housing Navigation Center



Source: OCA, March 2021

The City purchased the defunct indoor skydiving facility at 1401 Imperial Avenue to use as a housing navigation center. The center would provide services to people experiencing homelessness. The City used Community Development Block Grant funds from the United States Department of Housing and Urban Development to purchase the building for \$7 million in January 2018. See **Appendix C** for details on our findings related to this transaction.

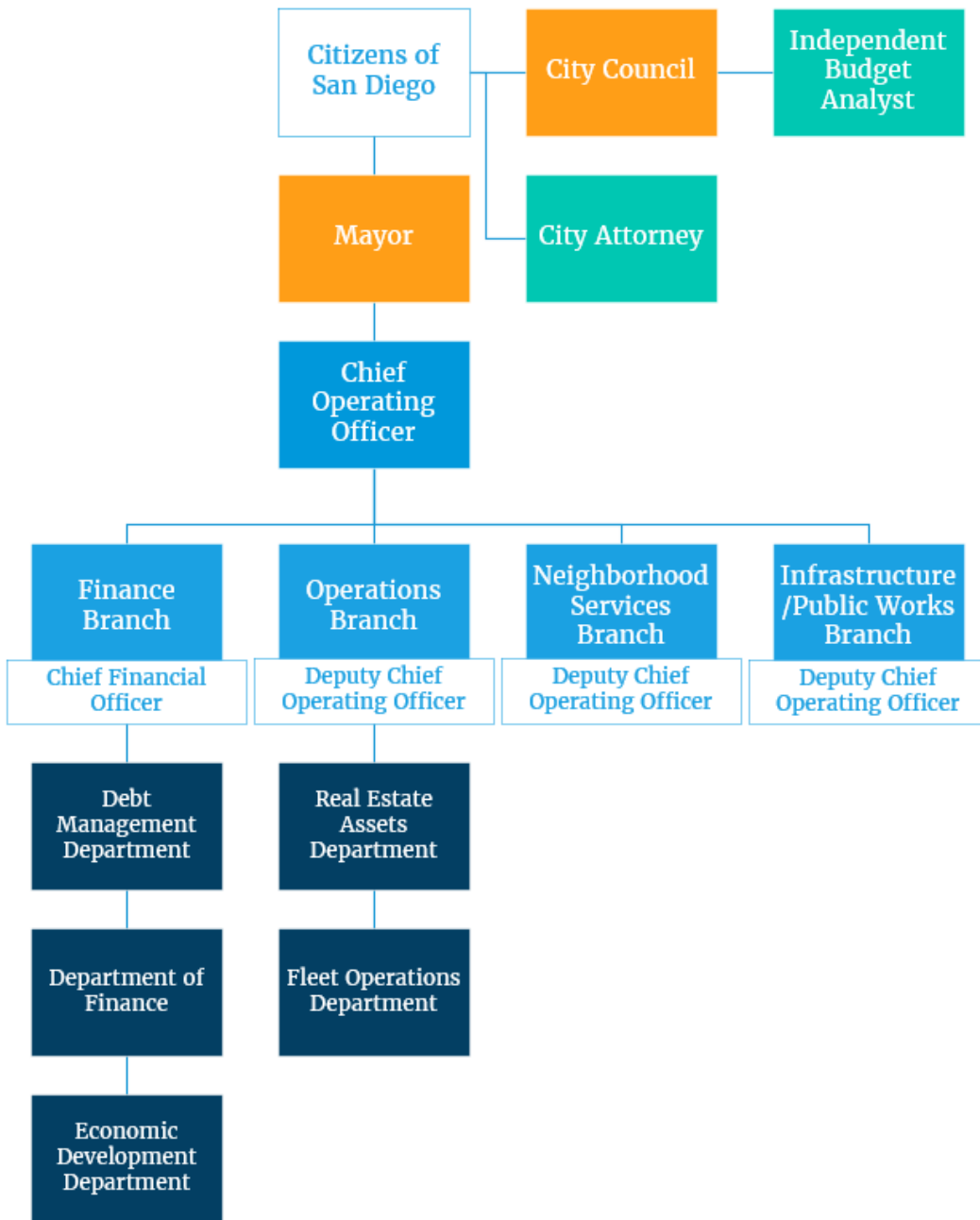
How the City Acquires Buildings

In the City's strong mayor form of government, the Mayor is the ultimate decisionmaker who relies on a hierarchy of City staff and their expertise to inform the Mayor of the City's critical issues. The Mayor oversees and approves all policy proposals to City Council, including proposals for building acquisitions. The Mayor is part of the City Administration, which also includes a Chief Operating Officer and several Deputy Chief Operating Officers who oversee the City's departments. The Mayor and City Management rely on the professional expertise of departments

and individuals within this hierarchy to make sound proposals to City Council. **Exhibit 6** below shows how the City was organized during the time of the acquisitions in our scope.

Exhibit 6

City Organization of Key Departments Involved in Building Acquisitions from FY2015 to FY2019



Source: OCA generated based on City organization chart from 2016.

***Real Estate Assets
Department***

The City's Real Estate Assets Department (READ) is the City's centralized real estate department for acquiring buildings and land through purchase or lease agreements. READ provides this service to client departments within the City. Therefore, acquisitions are centralized at READ, but the decision to purchase or lease a property is initiated and made by the individual departments with the approval of the City Administration, including the Mayor, and ultimately, City Council. READ primarily acts as a conduit to effect the requested acquisition, with the aid of several departments in the City that play key roles in the property acquisition process. Generally, City departments, with the approval of their respective Deputy Chief Operating Officers, initiate acquisition requests to READ and READ effects the transaction. However, the City Administration, including the Mayor's Office, can also initiate acquisition requests.

READ primarily receives requests from City departments to acquire a property via a services request form. If a department does not have a specific property in mind, READ will help the department identify a property and will sometimes identify suitable alternatives. According to READ, departments are responsible for conducting their own due diligence on a property prior to acquisition. Due diligence in real estate refers to the buyer's responsibility of investigating facts about the fundamentals of the property, seller, financing, and compliance obligations to reduce and mitigate financial uncertainties. Thus, according to READ, client departments are responsible for obtaining their own building and environmental condition assessments and for ensuring that the property otherwise meets the department's needs. READ primarily negotiates a transaction on behalf of the client department. READ's appraisal section helps either conduct or facilitate a building appraisal with the use of a City-approved contractor.

Other City Departments

City real estate transactions are broader than the functions that READ manages. As described below, other departments are involved in real estate transactions, including the City Attorney's Office, Debt Management, and the Department of Finance.

Client departments direct much of the acquisition process.

Client departments are those who wish to acquire property or a building for a specific purpose. However, the business case and funding process are usually approved in consultation with the department's Deputy Chief Operating Officer and the City Administration. Once approved, client departments submit their acquisition request to READ. Importantly, READ is only responsible for acquiring the property; it is not currently responsible for ensuring that the acquired property meets the client department's intended purpose.

The City Attorney's Office generally advises on the legal implications of a transaction.

This legal review includes answering questions as to whether the transaction conforms to state law, council policy, and municipal code, for example. Although the City Attorney's Office would prefer to be brought in at the earliest stage of a transaction, the stage at which it becomes involved is generally at READ's discretion. It is not unusual for the City Attorney's Office to be brought in after negotiations to review or prepare the contract. The City Attorney's Office typically gets involved when a letter of intent has already occurred between the department and the outside seller/owner.² The City Attorney's Office then builds that term sheet into a set of transactional documents that go through an approval process. Although the City Attorney's Office necessarily relies on READ and City departments to determine what due diligence is prudent in terms of physical inspections for a property, it may recommend certain types of legal due diligence, like title reports. According to the City Attorney's Office, most of the attorneys in the Real Property Unit review the due diligence documents to see if there is anything particularly alarming from a legal perspective, although the City Attorney's Office advised that the attorneys are not experts in physical due diligence. The City Attorney's Office stated that should it find any issues with a real estate transaction or its due diligence, it will communicate these issues with the project's property agent. If the attorney

² A letter of intent is a document declaring the preliminary commitment of one party to do business with another. While not binding, a letter of intent can help clarify the points of a deal or provide protection should a deal collapse.

finds that the issues are not being properly addressed, they will elevate the issue to the READ Director and/or the Mayor's Office. If the City Attorney's Office deems the issues to be a significant risk, it would consider issuing a memo. The City Attorney's Office also provides written comments when reviewing the staff report to City Council for each acquisition.

The Finance Branch of operations is also involved in real estate acquisitions. Although client departments are responsible for ensuring they have appropriate funding for a transaction, the Chief Financial Officer, according to the City Charter, must certify in writing that the money required for a contract, agreement, or obligation is available for that transaction. The Chief Financial Officer is also responsible for oversight of the City's financial management, treasury, risk management, and debt management functions.

Depending on the funding source, various departments within the Finance Branch are responsible for reviewing the availability of funds. For example, Debt Management becomes involved in a real estate transaction when the City Administration wants to finance something. Typical financing options include bond issuances, loans, notes, or lines of credit. For most financing measures and capital projects, a clear path exists that is understood by the Chief Financial Officer, Department of Finance, and Debt Management. This path involves financing for capital projects or for acquiring buildings such as 101 Ash. This process starts at the City Administration level and moves to Debt Management. Debt Management puts together a financing plan that involves answering questions such as:

- What is the property? What are its characteristics?
- What is the financial plan for completing the project?
- What are the costs and benefits (both quantitative and qualitative) of acquiring the property?

The Department of Finance provides services to the Mayor and serves as an internal fiscal consultant to the City. The Department of Finance has a clear role as it relates to certification of funds, budget availability, review of fiscal impact of a transaction, and ensuring compliance with use of restricted

funding sources. However, depending on the complexity level of a transaction, the Department of Finance stated that the Mayor determines the appropriate level of review, involvement, and financial oversight from the Department of Finance.

The Economic Development Department implements economic and community development programs to create and sustain a resilient and economically prosperous City.

Among its many responsibilities, the Economic Development Department administers funds from the Community Development Block Grant (CDBG) program, which are provided from the U.S. Department of Housing and Urban Development (HUD). These funds can be used for several purposes, including for job readiness and economic development programs, public infrastructure and nonprofit facility needs, affordable housing, homelessness, and services for vulnerable populations. If the City Administration wishes to acquire property using CDBG funds, the property must meet one of these HUD-approved purposes. The Economic Development Department approves and signs off on the use of CDBG funds for property acquisition and reports this information to HUD.

City Council Oversight

City Council is the City's legislative branch. As such, City Council approves the City's annual budget, authorizes the issuance of general obligation and revenue bonds, and oversees City contracts, such as leases and acquisitions. READ typically presents to City Council on real estate transactions, even though the transaction is on behalf of the client departments.

City Council Committees often discuss legislative matters prior to placement on the City Council docket. There are eight standing City Council Committees, with Councilmembers serving on each. Each committee focuses on a different subject area. READ is assigned to present real estate transactions to the Land Use and Housing Committee, known as the Smart Growth and Land Use Committee until January 2019. This committee's area of responsibility includes real estate assets, planning, land use, affordable housing, General Plan amendments, land development code, and permanent supportive housing. While real estate transactions are supposed to be presented to the requisite committee prior to presentation to City Council, this is

not always possible because of the urgency of a transaction. Therefore, READ staff may elect to have their item heard at a different committee, committee staff may direct the item to a different committee, or READ staff may request to direct docket an item to City Council and include the reason why an item did not go to a committee.

The Independent Budget Analyst provides budgetary and policy analysis for the City Council. According to the Municipal Code, the Independent Budget Analyst's designated function is to assist the City Council in the conduct of budgetary inquiries and in the making of budgetary decisions. This may be accomplished by preparing fiscal and economic project analysis as directed by the City Council, providing policy research and analysis on proposed legislation, preparing such other reports relating to budgetary and legislative policy concerns as directed by the City Council, and making recommendations to the City Council in connection with the analyst's studies. City Council appoints the Independent Budget Analyst who serves at the pleasure of City Council and may be removed at any time.

Real estate transactions, as they must be approved by City Council, are one of the many transactions that the Independent Budget Analyst's Office reviews. According to the Independent Budget Analyst, the City Administration and Mayor's Office must provide it with all the information necessary to analyze a transaction prior to presentation to City Council. However, there is no definitive timeline as to when the Independent Budget Analyst should become involved.

Audit Results

Finding 1: The prior City Administration did not follow best practices when acquiring more than \$230 million of major real estate assets due to unclear roles and responsibilities, resulting in significantly increased costs and underutilized facilities.

From 2015 to 2019, the City acquired five buildings, each worth more than \$5 million.³ The City acquired the 101 Ash Street building for office space, the Civic Center Plaza and King Chavez High School property for office space and to lease out, the Imperial Avenue indoor skydiving facility to use as a Housing Navigation Center, the Othello Avenue Kearny Mesa Repair Facility to repair fire trucks, and the Super 8 Hotel on Palm Avenue to use as transitional housing for participants in the San Diego Misdemeanants At-Risk Track (S.M.A.R.T.) Program.⁴ We evaluated each of these transactions and found that the City did not follow best practices when acquiring the buildings, resulting in the City potentially overpaying for buildings it did not fully understand the condition of, renovation costs significantly above estimated costs, and buildings sitting vacant or not used for their intended purpose. As outlined in **Exhibit 7**, the City lacks policies to implement best practices, causing the City to miss key steps in the acquisition process. The following sections discuss these issues in greater detail.

³ For our scope, we defined “acquired buildings” as buildings the City purchased, entered into a lease-to-own agreement for, or entered into a long-term lease for.

⁴ For details on our findings related to each building, see Appendices A-E.

Exhibit 7

The City's Lack of Policies for Ensuring It Follows Real Estate Best Practices Contributed to Costly Consequences

Real Estate Best Practices	Addressed in City Policy?	Effect
Departments have defined roles and responsibilities during the acquisition process.	No	City does not have information on the condition and value of the buildings acquired, as each department understands elements of due diligence to be someone else's responsibility.
Documented legal review communicates risks presented in the transaction to decisionmakers.	No	Decisionmakers unaware of legal risks to the City presented in the contract; City faces unexpected costs and reduced legal recourse.
Economic analyses clearly lay out all costs and compare viable alternatives.	No	Decisionmakers unaware of true cost of buildings acquired. City acquires buildings for more than they are worth to the City.
Building acquisitions fit into an overall real estate strategic plan .	No	City is reactive, rather than planning for future need and providing ample time for negotiations.
Each building acquisition has a specific purpose and business case .	No	Buildings sit vacant or not used for their intended purpose.
Real estate consultants have a contract with the City and complete required financial disclosures .	No	Consultant has potential to influence acquisition decisions while the City does not have protections to ensure the consultant acts in the City's best interest.

Source: OCA generated based on OCA's review of acquisition documents for the five building acquisitions in our scope.

The City does not have clearly defined roles and responsibilities for those involved in building acquisitions, causing critical steps to fall through the cracks.

One of the clearest breakdown points in the building acquisition process that led to the investment in the 101 Ash Street building was the City failing to gather sufficient information on the condition and value of the building (also referred to as due diligence).⁵ The City did not have sufficient, independent information on the condition and value of the building and therefore could not determine the investments the building would require to use the building as intended. Compounding this issue, the City Attorney's Office's legal review did not appear to result in written advice flagging the importance of having a thorough understanding of the building's condition. The structure of the acquisition and the contract meant the City was undertaking the risk of the building's condition and severely limited the City's ability to hold the seller accountable if there were any surprises. These two issues together—the legal risk that elevated the importance of the due diligence and the lack of due diligence conducted by the City—were primary factors that led to the City's poor investment in 101 Ash.

A primary factor that led to the lack of due diligence and the legal risk not being communicated in writing is that the City does not have clearly defined roles and responsibilities for each of the main elements of a building acquisition. The City's current policy on real estate acquisitions has not been updated since 1975 and does not address key steps in the acquisition process. According to the United States Government Accountability Office's Standards for Internal Control in the Federal Government, management should assign responsibilities to discrete divisions and ensure divisions can communicate quality information necessary to fulfill a goal—such as successfully acquiring and using a building.

The City lacks clear guidance on who is responsible for due diligence, leading the City to acquire buildings without understanding the buildings' condition and requiring the City to spend significantly more money than intended. The Real Estate Assets Department (READ) is responsible for assisting

⁵ Our report uses the term due diligence in real estate to refer to the buyer's responsibility of investigating facts about the fundamentals of the property, seller, financing, and compliance obligations to reduce and mitigate financial uncertainties.

City departments in acquiring property and leases. However, the City lacks documented guidance on what specific responsibilities this entails. We found that READ viewed its role as responding to the needs of the City departments rather than driving the acquisition process. As such, READ reported that much of the due diligence, such as contracting for an asbestos review or assessments of the building's condition, is up to the acquiring department and is not READ's responsibility unless the department requests it. However, City departments reported that they understood due diligence to be READ's responsibility, as READ staff are the experts in real estate acquisitions. Acquiring departments said they would rely on READ's expertise to know what due diligence steps to take when acquiring a building, and would not necessarily know what assessments of the building to request.

Without clarifying the party responsible for ensuring the City has conducted sufficient due diligence, the City may continue to acquire buildings without understanding the buildings' true conditions and could overpay for buildings. Finding 2 details the specific types of due diligence the City should conduct. READ, as the City experts in real estate, should ultimately be responsible for gathering, reviewing the quality of, and reporting the findings of due diligence. Without a party clearly responsible for ensuring appropriate due diligence is conducted, the City may purchase a building that then requires an unexpectedly large investment before it can be used, such as the case with 101 Ash. READ told City Council the City was purchasing 101 Ash for \$72.5 million and that the building needed \$5 million in tenant improvements—a power wash and some paint and carpeting. However, after conducting due diligence to understand the building's condition, the City now estimates 101 Ash needs \$115 million in improvements—including replacing the heating, ventilation, and air conditioning system; updating the fire suppression system; and other plumbing and electrical repairs.⁶ See **Exhibit 10** on page 24 for detail.

⁶ The \$115 million in improvements is a contractor's preliminary estimate. The City has not received a finalized estimate.

The City Attorney's Office did not consistently document and communicate the legal risks presented in the contracts to acquire buildings, resulting in decisionmakers lacking crucial information when weighing the pros and cons of these multi-million dollar acquisitions.

According to the San Diego City Charter, the City Attorney's Office prepares and approves as to form all City contracts. The City Attorney's Office reports that although it reviews the contracts, the decision to undertake the legal risk presented in the contract is a policy decision made by the City Administration.⁷ The City Attorney's Office said it notifies the project lead of the risk but does not consistently document risks of the contract for City Council. Further, the City and the City Attorney's Office do not have a policy requiring the City Attorney's Office to provide a detailed legal analysis to City Council for building acquisitions. Not having a written summary of the legal risks raised in each contract to purchase a building, with mitigating and aggravating factors impacting those risks, means that the risks may not be consistently communicated to the contract decisionmakers—the Mayor, City Management, and City Council.

For example, the contract to lease-to-own 101 Ash contained multiple legal risks that do not appear to have been documented and formally communicated to City Management or the City Council. First, the contract states the City “acknowledges that it is sufficiently familiar with and knowledgeable about the physical condition of the Premises, including any elements of deferred maintenance or the presence of any Hazardous Materials and *is not relying on any representation or warranty by the Landlord with regard to the condition of the Premises [emphasis added].*” However, the City was actually relying on building condition assessments that were conducted by the previous owners of the building. Further, the contract states the City took on all risks of the building condition “AS IS” and that “all risks...are to be borne by” the City. This language means the City takes on all costs associated with the building, even if later the City finds out that

⁷ When entering a real estate contract, there are several legal risks that must be considered, such as misrepresentation and/or failure to disclose an important feature of a property (e.g., structural or foundation issues). Other risks may include brokers' failure to disclose dual agency or to advise a buyer of known environmental hazards on a property. Legal review can help mitigate these risks.

the building has significant issues and cannot be used as an office space as intended because of the building's design or condition.

Second, in the lease-to-own contract for 101 Ash, the City takes on the risks of the building condition, with the understanding that the seller disclosed what it knew about the property's condition. However, the City leased 101 Ash from a company that never occupied the building. Because the seller had not occupied the building, the seller likely did not have first-hand knowledge of the condition of the building. Therefore, the risk to the City is that there may be issues with the building that the seller did not disclose. The seller would not be at fault for not disclosing those issues because the seller never occupied the building and thus may not know about any problems.

These risks may have been acceptable to the Mayor, City Management, and City Council, had the risks been mitigated by adequate due diligence. In other words, it may have been acceptable for the City to sign a contract with these provisions, had the City had a thorough understanding of the condition of the building. However, the legal risks were heightened by the fact that the City did not gather its own independent information to understand the condition and value of 101 Ash. The City Attorney's Office staff did not raise any concerns in writing regarding these legal risks in the contract.

Without both (1) a written, documented checklist of the due diligence the City conducted or did not conduct, and (2) a written summary of the legal risks and mitigating or aggravating factors in the contract to purchase a building, decisionmakers, such as the Mayor, City Management, and the City Council, may not be aware of contract provisions that place the City at risk before approving the purchase.

The City does not have a clear decisionmaker within the administration responsible for leading acquisition decisions, making responsibilities unclear and allowing essential information to be decentralized or simply not obtained.

When asked who made the day-to-day decisions on the buildings the City acquired, READ stated that the acquiring department made the decisions on the acquisition, such as the funding

method, what due diligence to conduct, whether the building will fit the department's needs, and what tenant improvements are necessary. The acquiring departments often reported that they made some of the decisions, such as funding or tenant improvements, but that READ or others were responsible for some of the decisions. In some cases, such as 101 Ash, Civic Center Plaza, and the Housing Navigation Center, staff reported the acquiring department as the whole City, and indicated that there was no lead decisionmaker beyond the Mayor.

Across all five building transactions that we reviewed, none of the buildings had a clear lead decisionmaker beyond the Mayor. Although the Mayor is the chief executive officer of the City, the Mayor oversees thousands of employees and dozens of departments. According to the Government Accountability Office's Standards for Internal Control, management should assign responsibility and delegate authority to key roles that take overall responsibility for a specific goal. Leading the purchase of a building, as it arises, is a specific goal. Within City operations, each building acquisition should have someone in the key role, such as a department director, taking ownership of the purchase with clear reporting lines up to the Mayor.

Without a lead party making decisions at the day-to-day level, responsibilities may fall through the cracks as no one central party is responsible for gathering all information and deciding what is relevant to report to the decisionmakers. For example, for the Palm Avenue Hotel, READ staff reported the Economic Development Department as the acquiring department making decisions on going forward with the due diligence, funding, and acquisition of the hotel. Economic Development Department staff indicated they were providing the funding. The City Attorney's Office said they were the lead department for the programming behind the purchase and the Economic Development Department provided the funding, but the acquiring department for the building itself was the Mayor's Office. This lack of clarity was present with most purchases in our scope.

For office buildings that have a Citywide purpose, like 101 Ash and Civic Center Plaza, READ or the Chief Operating Officer may be the appropriate party to lead the acquisition. However, READ

staff reported that they do not drive decisions such as determining the best funding method and the tenant improvements necessary. Written policies and procedures should clarify that the responsible party may rely on the expertise of the Debt Management Department, the City Attorney's Office, or other departments for input on the acquisition, but one specific party is responsible for collecting sufficient information and reporting it to the City's ultimate decisionmakers—the Mayor and City Council. This would clarify to READ staff and other acquiring departments their responsibilities and ensure information does not fall through the cracks.

Economic analyses highlighting the costs and benefits of acquiring the buildings did not include significant information, including clearly detailed costs of the funding structures chosen and tenant improvements.

We found that the City also lacks policies requiring an economic analysis for major real estate acquisitions and laying out what the economic analysis should include. Without a policy detailing what should be included, City decisionmakers may not understand what costs went into the building's acquisition price and may not have the opportunity to ensure the City is investing in the best available option.

The City lacks a policy clearly identifying the party responsible for conducting a detailed economic analysis and presenting the analysis to City Council with all relevant information. Without a policy, it is unclear who is responsible for conducting the economic analysis and ensuring its accuracy. READ has stated that it is the acquiring department's role to conduct the economic analysis, while an acquiring department assumed that comparing the acquisition to other properties was READ's role and that the funding structure analysis is conducted by the Debt Management Department or the Department of Finance. While the Department of Finance and the Debt Management Department have expertise that should be engaged in the process to ensure accurate economic analysis and selection of the best funding method, READ should ensure that the acquiring department and the City are getting the best deal for taxpayers and should ensure that all of the necessary information is presented to City Council.

City staff did not clearly describe all of the costs that went into acquiring 101 Ash and Civic Center Plaza. The City acquired 101 Ash and Civic Center Plaza through lease-to-own agreements. In its staff report and presentation to City Council, READ did not detail the additional costs of the lease-to-own structure, including:

- The fees and profit paid to the landlord;
- The increased cost of financing through the landlord rather than using the lower interest rate the City receives on funding; and
- The fact that leasing the building means the City does not own the building for 20 years and cannot use the building as an asset to leverage for future City borrowing.

Although staff may have believed leasing-to-own these buildings was the best financial structure available at the time, READ should have clearly communicated to City Council what the City was agreeing to pay.

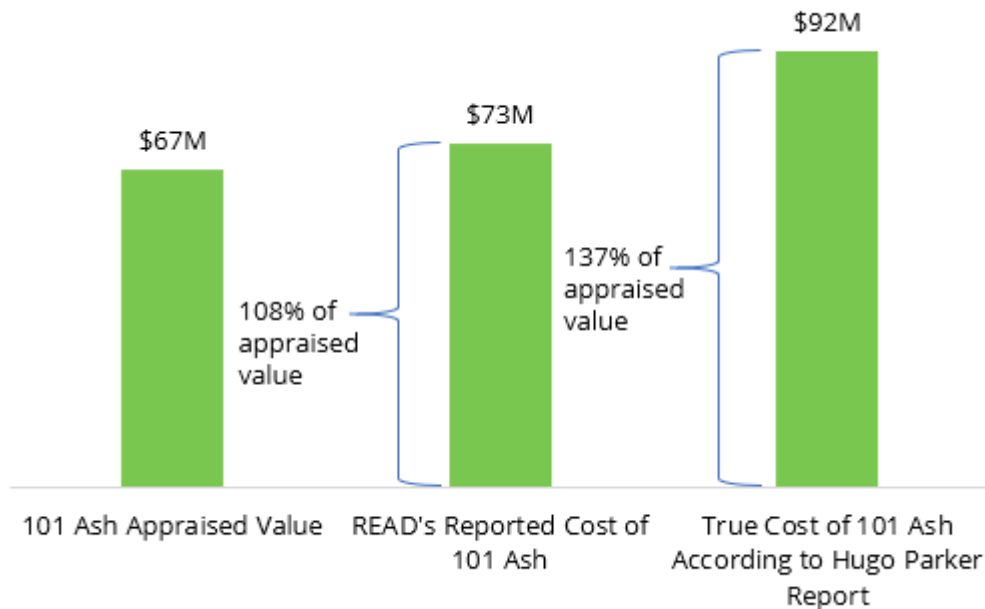
For example, for 101 Ash, the staff report stated that the City was getting the seller's purchase price for the building—\$72.5 million. However, a retrospective report on the 101 Ash acquisition found that the City's true purchase price for 101 Ash was about \$92 million—the \$72.5 million for the building, plus \$5 million for the tenant improvement loan and \$14.5 million in fees and profit to the seller.⁸ READ's staff report did not include any mention of these costs. READ's staff report simply stated the building price as \$72.5 million and that the City would pay \$1.70 per square foot per month. While this number is accurate, \$1.70 per square foot per month totals to about \$128 million over 20 years, READ never totaled the \$1.70 per square foot per month cost for City Council in their staff report, so the total amount in lease payments was unclear. READ did not account for what made up

⁸ In 2020, the City contracted with Hugo Parker, LLP, among others, to review the 101 Ash transaction. The publicly released version of their report can be found here: https://onbase.sandiego.gov/OnBaseAgendaOnline/Documents/ViewDocument/Att.%201_%20%20Forensic%20Review_Preliminary%20Report%20on%20101%20Ash%20Street%20_PUBLIC_July%202020.pdf?meetingId=4099&documentType=Agenda&itemId=191555&publishId=406740&isSection=false

the difference between the stated \$72.5 million purchase price and the \$128 million total the City would be making in lease payments to the seller. **Exhibit 8** outlines the difference between 101 Ash's appraised value, READ's stated cost of the building, and the true cost of the building according to the retrospective report conducted by Hugo Parker in 2020. If the City Council had been provided these costs in a straightforward manner, it would have better allowed the City Council to weigh their interest in paying \$92 million for a building with an appraised value of only \$67.1 million.

Exhibit 8:

READ Did Not Clearly Report the True Cost to Acquire 101 Ash



Source: OCA generated based on appraisal for 101 Ash, staff reports on 101 Ash, and Hugo Parker report.

City staff underestimated the tenant improvement costs necessary to use the buildings as intended. **Exhibit 9** shows that for three of the five buildings in our scope, building improvements are estimated to cost the City 48 percent to 2,724 percent more than initially presented to City Council. We found that for most of the building acquisitions, the cost of tenant improvements was based on an estimate from staff that was not

based on historical data on the cost of similar projects, building condition assessments, or test fits.

Exhibit 9

For Three of the Five Buildings, READ Underestimated How Much the Tenant Improvements Would Cost by Millions of Dollars

Building	Tenant Improvement Costs READ Presented to City Council for Approval When Acquiring the Building	Actual Tenant Improvement Costs as of June 2021	Additional Tenant Improvement Costs Necessary to Use the Building as Intended	Total Estimated Improvements Necessary	Percent Increase in Costs from Presented Estimate to Current Estimate
101 Ash	\$5.0 million	\$26.0 million	\$115.2 million	\$141.2 million	2,724%
Repair Facility	\$6.5 million	—	\$14.8 million	\$14.8 million	128%
Palm Avenue Hotel	\$4.5 million	\$6.5 million	—	\$6.5 million	48%

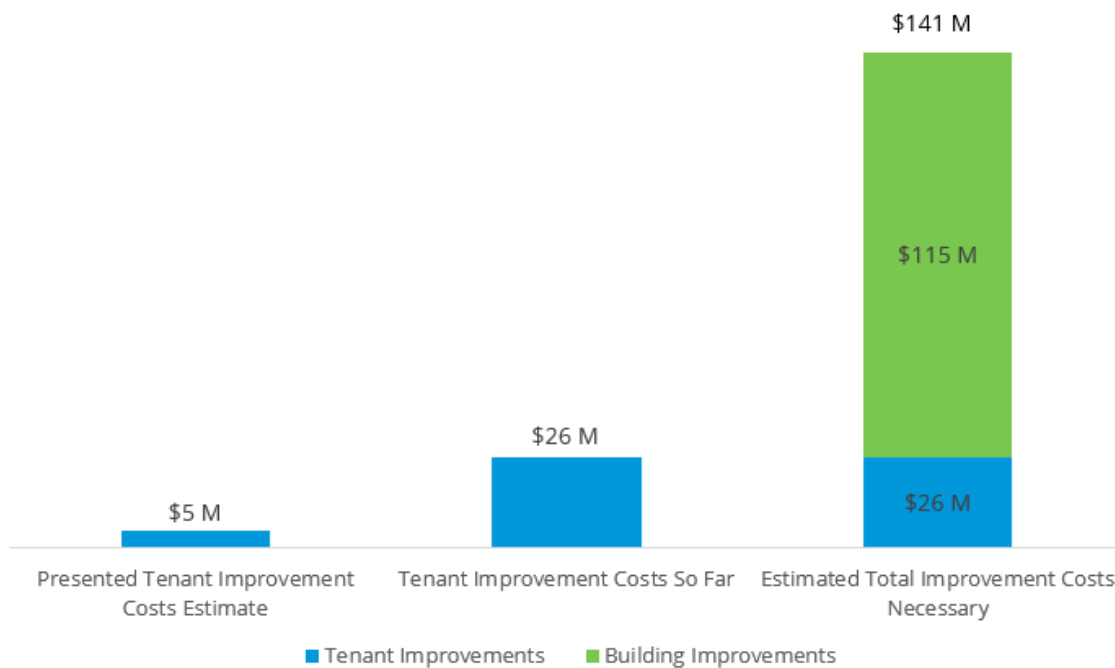
Source: OCA generated based on review of documents for 101 Ash, Kearny Mesa Repair Facility, and the Palm Avenue Hotel.

For example, when acquiring 101 Ash, the City did not contract for a building condition assessment or conduct a test fit of the building to ensure it could fit the 1,100 employees the City planned to move into the building. READ estimated 101 Ash needed \$5 million in tenant improvements based on staff's estimate of the cost for new paint and carpet throughout the building. However, when the City contracted for those tenant improvements, the test fit showed the building would only fit 800 employees without significant renovations. To fit the 1,100 employees and use the space as planned, contractors estimated the cost to actually be \$26 million.

Beyond the \$26 million, in 2020, the City contracted for its own complete building condition assessment to use the space as intended and the contractor estimated 101 Ash needed \$115.2 million in additional improvements. These improvements include updating the heating, air conditioning and ventilation system; fire suppression system; and addressing issues with accessible asbestos. Therefore, if the City plans to occupy 101 Ash as intended, the total tenant improvements are estimated to cost 2,724 percent more than READ presented to City Council when proposing the City purchase the building. **Exhibit 10** shows this difference.

Exhibit 10

Improvement Costs for 101 Ash are Estimated to Total \$141 Million, \$136 Million More Than Staff Presented to City Council



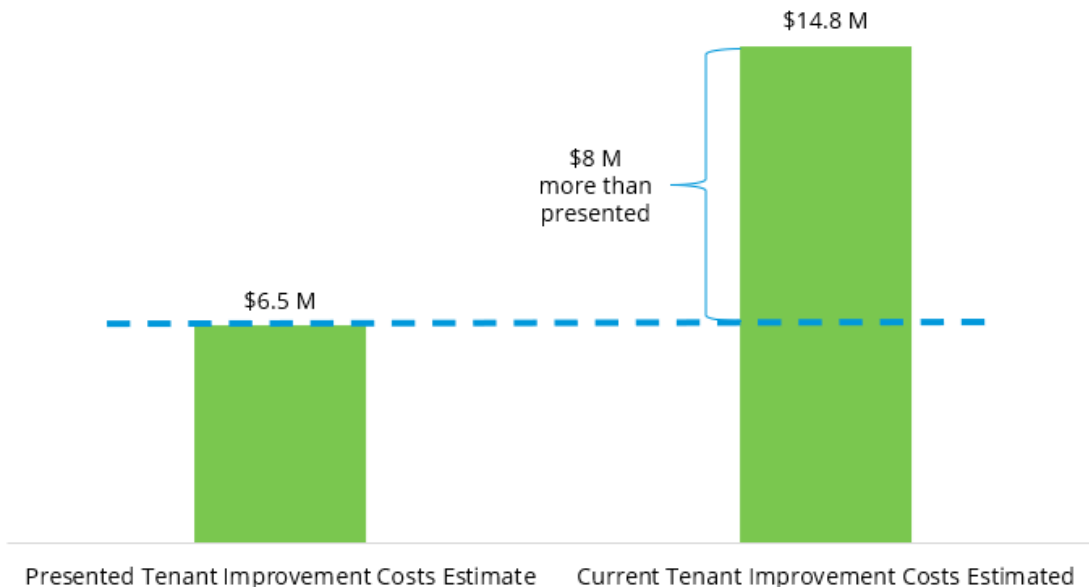
Source: OCA generated based on review of staff reports on 101 Ash and a consultant's building condition assessment of 101 Ash.

Similarly, for the Kearny Mesa Repair Facility (Repair Facility) that the City leased to repair fire trucks, staff presented to City Council that tenant improvements would cost \$6.5 million. City staff did not base this estimated cost on a test fit or building condition assessment. Once the City leased the property, the City

contracted with consultants to estimate the true cost to use the building to repair fire trucks as intended. As of January 2020, the City estimated the needed tenant improvements to cost \$14.8 million—a 128 percent increase above the costs initially presented to City Council when staff proposed leasing the building. **Exhibit 11** shows this difference.

Exhibit 11

Tenant Improvement Costs for Kearny Mesa Repair Facility Are Estimated to Total \$14.8 Million, \$8 Million More Than Staff Presented to City Council



Source: OCA generated based on review of staff reports and cost estimate for the Kearny Mesa Repair Facility.

Economic analyses did not include comparisons to other properties. When acquiring office space, staff presented the cost of acquiring the 101 Ash building and only compared that cost to continuing to lease other office space for 20 years at ever-increasing rates. No other alternatives were included, such as a direct purchase of a different office building. When acquiring the other properties we reviewed, City staff did not compare the cost of the building acquired to any alternatives at all.

The City should compare base rent, tenant improvement costs, and operating expenses together to other buildings' terms, rather than comparing base rent to base rent without consideration of the additional costs of tenant improvements.

The City's real estate team should have an overall plan on how to house its employees and should consider comparable purchase or lease options, rather than presenting one option to City Council.

READ addresses the City's real estate needs as situations arise, without a central strategic plan.

Another factor leading to major problems with real estate acquisitions is the absence of a central strategic plan to guide decisionmaking. A clear vision and strategy are essential for any organization to successfully fulfill its mission. Real estate best practices dictate that a strategic real estate strategy should be adopted to help ensure that properties the City acquires fit into a coherent long-term plan that has been publicly vetted and approved by City Council. Although READ has a Portfolio Management Plan (PMP), this plan does not sufficiently serve as a strategic real estate plan and is not official City policy because City Council has not approved it. Without a strategic real estate plan for the City's use of space and office space, READ addresses the City's real estate needs as they arise, and decisions are made without consideration of their impact on other City real estate. Additionally, City Council is not informed as to how proposed real estate decisions fit into an overall Citywide real estate plan.

For example, although the PMP includes high-level descriptions of READ's intent to "organize office space," it does not include specific details or actionable plans that READ or City Council can execute.⁹ Grubb and Ellis' 2007 review of READ stated that a strategic plan should contain the following elements:

- A review of the portfolio;
- A review of the City's office space building by building, including:
 - Each building's condition;
 - Each building's cost, both total cost and per square foot cost; and
 - Each building's upcoming events, such as lease expirations and renewal options;
- An operating plan for corporate property;

⁹ <https://www.sandiego.gov/sites/default/files/portfoliomanagementplan.pdf>

- A review of the City's current and future demand for office space, by department and floor;
- The portfolio's response to the City's office space demand and request for action;
- An investment or disposal plan for surplus property;
- Market research and specific parameters for anticipated transactions in support of the plan; and
- A request for authority to act within those parameters.¹⁰

While the PMPs from fiscal years 2016 to 2019 contain some of these elements, the elements in the PMP are generally too high-level for City Council to make decisions.

Best practices recommend that the strategic plan be presented and approved by a designated oversight body (like City Council or a council committee) and that real estate decisions be considered in regard to this plan.

However, the PMP has never been presented to City Council or a relevant council committee since 2011. And when it was first created in 2010, READ presented the PMP to a council committee as an information-only item and never presented it to the full City Council for approval. Although our office recommended in a July 2018 audit that READ formally present the PMP to City Council, as of this audit's publish date, READ still has yet to do so.¹¹ Without having the PMP presented, discussed, and approved in an open City Council meeting, the PMP cannot provide City leadership and the public a clear understanding of the City's real estate assets and how they can best be utilized to benefit the citizens of San Diego.

For example, because the City does not have a strategic plan regarding its use of office space, the City purchased 101 Ash without a full understanding of which departments, aside from the Development Services Department, would occupy the building and the how the space would be organized to

¹⁰ <https://www.sandiego.gov/sites/default/files/legacy/real-estate-assets/pdf/grubbellis070131.pdf>

¹¹ https://www.sandiego.gov/sites/default/files/19-002_real_estate_assets.pdf

accommodate the various departments. As a result, the City's initial plan to have 1,100 employees occupy 101 Ash within months of acquisition, at a cost of \$5 million in tenant improvements, changed almost immediately after the City signed the lease-to-own agreement in December 2016. READ hired a consultant who recommended that the City renovate all 19 floors at a cost of between \$22 million and \$32 million, a 340 percent to 540 percent increase in cost.

The City's subsequent decision to delay occupying 101 Ash, as originally intended, likely caused the City to spend more in leasing costs for office workers still housed in leased office space. Additionally, hundreds of City employees were forced to spend more time in subpar working conditions at the City Operations Building and the Executive Complex. Had the City followed a strategic real estate plan before acquiring the building, the City could have considered the cost of renovations and tenant improvements in the cost-benefit analysis and may have potentially decided on an alternative building that required fewer tenant improvements. Or, the City could have considered an alternative plan to house downtown workers in a potentially less expensive complex or area outside of downtown.

Amending the PMP or creating a new strategic real estate plan that is updated annually, presented to, and approved by City Council will help City Council to ensure that the City's real estate decisions are made in consideration with the City's overall real estate portfolio. A strategic plan should consider the following:

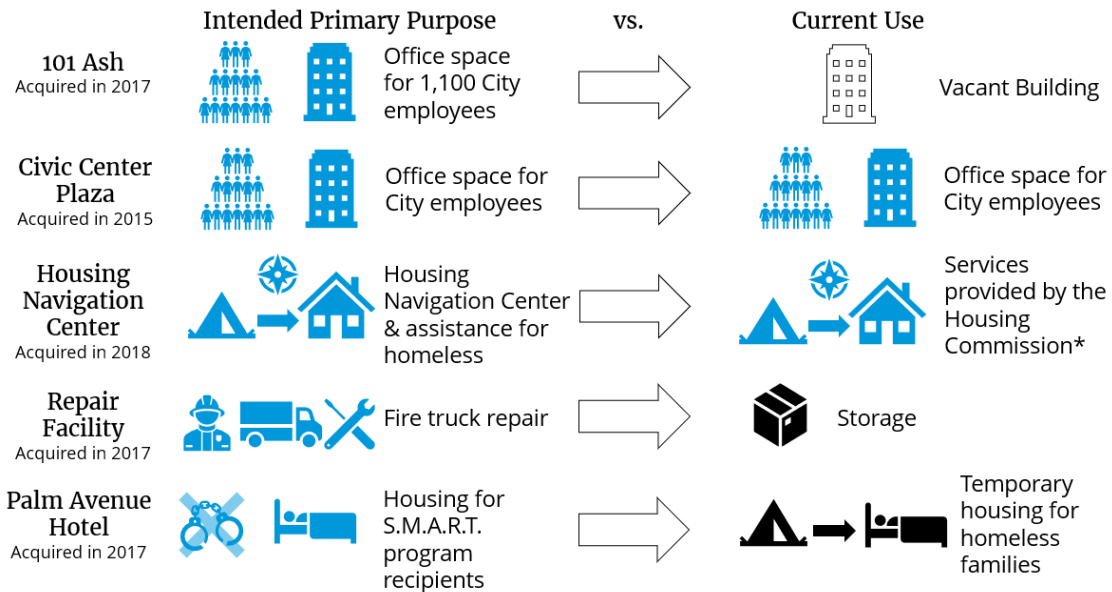
- A master plan for City office space that evaluates the cost of current rental space, the space needs of each department and how they might be optimized, the possibilities for consolidation, and alternative ownership and management structures;
- A strategic plan for office space utilization; and
- A set of explicit principles and goals that can serve as guidance for the decision-making process around the acquisition and disposition of real estate.

The City does not require the acquiring department to establish and present a clear business case.

Establishing and presenting a business case to READ or an oversight body for a property acquisition is crucial to determining the due diligence that follows during the acquisition phase of a property and for ensuring that a property is used for its intended purpose. Although the City has workspace request forms that indicate that a business case for a property acquisition should be submitted to READ, the workspace request form requires very little detail as to what the business case should entail. The workspace request notes that departments should submit a business case, a description of the kind of space they require, and their proposed funding for the space. We did not find evidence of formal business cases for each of the properties in our scope, nor did we find workspace request forms. Without an established and approved business case, there is a risk that property will not be used for its intended purpose. In fact, we found that several buildings in our scope are not being used for their intended purposes, as shown in **Exhibit 12** below.

Exhibit 12

Most of the Buildings the City Purchased Are Not Used for Their Primary Intended Purpose



*The Housing Navigation Center, acquired in January 2018, sat vacant for more than a year and a half while the City developed a program and secured a contractor.

Source: OCA generated based on review of staff reports, interviews with City staff, and tours of the buildings.

According to READ, departments, in consultation with their respective Deputy Chief Operating Officers and/or the City Administration, create their own business cases for an acquisition without READ's input. Once approved internally, READ receives the acquisition request and acts as a conduit to acquire the requested property. READ states that it is not responsible for ensuring that the acquired property meets its intended purpose.

Best practices dictate that a business case should answer the following questions:

- How will a proposed type of property meet a department's real estate or operational needs?
- Does the department have to be adjacent to related departments or functions?
- What quality of space does a department need?
- What special features should a property have that are not included in the existing property or other City properties, such as training space or separate entrances?
- How much space is needed compared with what is available or will soon be available in the City's portfolio?
- If additional space is required, what is the available space in the market when comparing costs, quality, and alignment with space goals?
- How does the proposed acquisition fit into the City's real estate strategy, portfolio, and a department's strategic goals?
- Does the amount proposed to spend fit into the department's or City's budget?

A business case for a potential property with clearly presented objectives can guide due diligence, prevent costly issues that may arise in the future, and ensure a property is used for its intended purpose. For example, READ, the Fleet Operations Department, and other departments pursued the long-term lease of the Kearny Mesa Repair Facility (Repair Facility) with a primary and secondary purpose identified: first as

a fire truck repair facility and second as a storage facility. However, because of the versatility identified in the property, staff did not conduct a sufficiently detailed test fit (and associated tenant improvement cost estimate) to ensure that the Repair Facility is suitable to accommodate fire truck repair prior to the City's signing of the lease.

It was only after the lease was signed that the City contracted for a full-scale design of the property that estimated the total renovation would cost \$17 million, far above the original estimate of \$6.5 million. As a result, City officials have spent more than three years trying to scale back the costs and the facility currently sits unused for its primary purpose while inefficiencies persist at the facility where the City currently repairs fire trucks and trash trucks.

The Mayor's Office did not have a contract with an influential advisor on building acquisitions and did not ensure the advisor had a duty of loyalty to the City—the advisor was then paid \$9.4 million by the buildings' seller.

In 2013, the Mayor at the time appointed an unpaid advisor to identify and assist in leasing downtown office space for the City. The unpaid advisor stayed on under subsequent Mayors, including the Mayor overseeing the building acquisitions the City executed from 2015 to 2019. We found that the advisor likely had significant influence in the 101 Ash and Civic Center Plaza acquisitions, including advising the Mayor and the READ Director at the time directly.¹²

The City's conflict of interest code for the Mayor's Office stipulates that the Mayor's Chief of Staff is responsible for documenting a Mayoral consultant's range of duties, along with a determination of the extent of their economic disclosure requirements. However, we found that the former Mayors' Offices did not document the advisor's duties and determine whether the advisor should disclose their economic interests as

¹² When we interviewed the former Mayor's Chief of Staff, we requested an interview with the former Mayor and he agreed to assist us in arranging this interview. However, the former Mayor's Chief of Staff did not respond to several subsequent emails requesting an interview with the former Mayor.

required.^{13,14} Without knowing the advisor's economic interests, there is a risk that the advisor influenced the decisions to acquire 101 Ash and Civic Center Plaza to their benefit, rather than to the benefit of the City. Notably, it appears that this risk may have materialized. According to the City Attorney's Office, the City subsequently discovered that the advisor was paid approximately \$9.4 million by the seller for 101 Ash and Civic Center Plaza together.

In addition, the former Mayors' Offices did not require the advisor to have a contract with the City. The former Mayor's Chief of Staff stated that he was under the impression that the advisor had a duty of loyalty to the City, but that he was not aware that the advisor was not under contract with the City during the time of these acquisitions. If the advisor had had a contract with the City, the contractor's duty of loyalty to the City would have been clearer. The City's general contract terms and provisions state that contractors are subject to all federal, state, and local conflict of interest laws, regulations, and policies. The terms state the contractor must establish safeguards to prohibit the use of their position with the City for a purpose that is or has the appearance of being motivated by personal gain. The terms also state that the City will determine if the contractor must disclose their relevant financial interests in a statement of economic interests. However, because the Mayor's Office did not ensure the advisor was under contract, the advisor was not subjected to these contract conditions, again placing the City at risk.

Recommendations:

Overall, we found that the City needs detailed policies assigning responsibilities for conducting key best practice steps when executing major real estate acquisitions. In addition, as the City Council has final approval authority over major building acquisitions, it is critical that the City Council and Independent

¹³ https://www.sandiego.gov/sites/default/files/mayor_appendix_a_and_b_final_passage.pdf

¹⁴ The department hiring the consultant is responsible for deciding if the consultant will be making government decisions or serving in a staff capacity and participating in making decisions and therefore must file a Statement of Economic Interests. To determine if the consultant must file a Statement of Economic Interests, the department hiring the consultant files a Determination of Applicability for Consultant form with the City Clerk's Office.

Budget Analyst have sufficient opportunity to review and ensure that key best practice steps have been completed prior to the execution of the deal. Therefore, in order to help ensure that the City has clear expectations for what steps will be undertaken when acquiring buildings, and who is responsible for completing each step, we make the following recommendations:

Recommendation 1

As the lead department, we recommend the Real Estate Assets Department (READ), in consultation with the Independent Budget Analyst (IBA), City Attorney's Office, and other departments as needed, create a new or amended Council Policy for City Council's approval that requires a best practices checklist for building acquisitions. READ and other departments as detailed in the new or amended policy would complete and present the checklist to City Council for every building purchase or lease agreement that requires City Council approval. The checklist in the Council Policy should establish the following steps to be taken and presented to City Council:

- a. Determination of how a building acquisition fits in the strategic plan detailed in Recommendation 3.
- b. Determination of what the building will be used for and to what extent the building fits the business case.
- c. Completion of a funding method analysis, with input from the Debt Management Department.
- d. Determination of estimated tenant improvement costs supported by relevant data. Tenant improvement proposals should be presented and approved with the building acquisition. Tenant improvements proposals should include detail on how the tenant improvements will ensure the building meets the City's needs and detail on the anticipated cost and timeline.
- e. Completion of an overall economic analysis including consideration of other acquisition options, with input from the Chief Financial Officer.
- f. Completion and presentation of a due diligence checklist (see details in Finding 2, Recommendation 5), including a high-level summary of the due diligence materials obtained by READ and their findings. The due diligence materials obtained by READ and provided at

least in summary to City Council should include but not be limited to appraisals, building condition and environmental assessments, and the assessments' findings. Findings from assessments may include the building's Americans with Disabilities Act compliance, the presence of hazardous materials, the results of a building systems investigation, and the results of an asbestos inspection.

- g. Identification and designation of a set City Council committee to oversee building leases or purchases that require City Council approval.
- h. Presentation of the City Attorney's Office's written analysis of the significant legal risks of the contract.
- i. Review of completion of items on the checklist by the IBA or the IBA's as-needed consultant to the best of their knowledge. This review may include an analysis of how well the best practices have been conducted.

City staff may note in the checklist if steps required in the checklist were not completed and why. City staff should provide material to the IBA to support each component of the checklist, including the rationale to not complete checklist steps. (Priority 1)

Recommendation 2

When drafting the Council Policy set out in Recommendation 1, we recommend that the Real Estate Assets Department (READ), in consultation with the Independent Budget Analyst (IBA), City Attorney's Office, and other departments as needed, create an Administrative Regulation to establish clear roles and responsibilities for City departments involved in the acquisition process or with expertise to contribute to the acquisition process. The Administrative Regulation that correlates to the Council Policy in Recommendation 1 should, at minimum, include roles and responsibilities for the departments listed below.

- a. **Acquisition lead.** The policy should set out the role and responsibilities of the acquisition decisionmaker, as well as the acquiring department, if the parties are different. READ can require the acquisition decisionmaker to provide information to READ for the

checklist, such as the business case for the building and the desired funding method.

- b. **READ.** READ's role in transactions should be clearly defined, including its responsibility in taking the lead on negotiations and conducting due diligence. READ should conduct an economic analysis of purchasing the building in question compared to other options, as well as an economic analysis of using the funding method recommended compared to other funding methods. READ should consult with the Department of Finance and the Debt Management Department for the economic analysis. READ should be the party responsible for completing the due diligence checklist and ensuring the information presented is accurate.
- c. **City Attorney's Office.** The City Attorney's Office should prepare and present a written legal analysis of the significant risks in each building's acquisition contract for all buildings that require City Council approval. The written legal analysis may be included as a dedicated section within the staff report to City Council or may take the form of a separate memo.
- d. **Independent Budget Analyst (IBA).** The IBA should be notified and provided all relevant information on building purchase acquisitions at the time a building has been identified and prior to the start of negotiations. The IBA would not be involved in the operations and management side of acquiring the building, but should be provided information to conduct a sufficient and timely analysis of the best practices followed or not followed. The IBA should also review the best practices checklist (as described in Recommendation 1) and hire a consultant for review of the checklist as needed. (Priority 1)

Recommendation 3

We recommend that the Real Estate Assets Department (READ), in consultation with the City Administration, develop and use a strategic real estate and office space plan. The plan should include the current space usage and a plan for future office space usage for City properties. The Council Policy described in Finding 1 should require READ to present the plan to the

designated City Council committee and the City Council for input, changes, and approval every two years. (Priority 2)

Recommendation 4

We recommend that the Council Policy set out in Recommendation 1 also require all contractors or advisors with significant input on real estate transactions to have a signed contract with the City and a determination form filed with the Office of the City Clerk by the contracting department. Additionally, we recommend that the policy in Recommendation 1 require the best practices checklist presented to City Council for real estate acquisitions to include a section disclosing any consultants or advisors to the City that were involved in the acquisition. Before presenting the checklist to City Council, the lead department on the acquisition should confirm with the Office of the City Clerk that each consultant or advisor listed has a Consultant Determination Form on file, and that any consultants and advisors have filed a Statement of Economic Interests form if necessary. (Priority 1)

Finding 2: The prior City Administration failed to conduct sufficient due diligence, limiting the City's understanding of the properties acquired and hindering its ability to negotiate.

As discussed in Finding 1 and in our appendices, the City did not follow numerous best practices when acquiring major real estate assets. Perhaps the most significant of these shortcomings was the lack of sufficient due diligence, and in Finding 2, we cover some key areas where the City failed to conduct due diligence in more detail.

Due diligence ensures the acquiring entity understands the potential value and costs of its investment. A sufficient understanding of the property and its condition allows the City of San Diego (City) to negotiate with an understanding of the maximum cost and acceptable level of risk the City is willing to undertake, given the property's condition and market value, its intended purpose, and comparison to alternatives.

Due diligence in real estate refers to the buyer's responsibility of investigating facts about the fundamentals of the property, seller, financing, and compliance obligations to reduce and mitigate financial uncertainties. It is best to undertake due diligence before a property is purchased or build in a contingency period within a contract that allows the buyer to investigate the property. If the investigation is not favorable to the buyer, the buyer can cancel the contract.

Conducting due diligence begins with understanding a transaction's objectives. For example, if an agency intends to purchase a building that it will immediately demolish, then a building condition assessment to assess the building's heating, ventilation, and air-cooling system would be unnecessary. But if the agency intends to occupy a building that was constructed in the 1960s, then a prudent agency would assess the quality of

those systems to avoid unforeseen costs in the future, and perform other types of inspections, such as for asbestos.

While the City conducted several elements of due diligence for the building transactions we reviewed, we found that the Real Estate Assets Department (READ) did not consistently ensure some key elements of due diligence were conducted, including independent appraisals, condition assessments, asbestos inspections, and test fits, as shown in **Exhibit 13** below. Completing these elements could have limited post-transaction surprises and future costs. For example, industry guidance notes that the hidden details of a property's condition can doom the financial merits of an otherwise profitable deal, turning the transaction into a costly mistake. The City's failure to follow due diligence best practices becomes incredibly relevant in reviewing what happened with several of the transactions that will be discussed in this section, particularly with the 101 Ash Street building. Additionally, we found that READ did not make available to City Council the elements of due diligence conducted for the acquisitions in our scope.

Exhibit 13

Due Diligence Elements Completed by the City Prior to Acquisition

Building	Independent Appraisal	Independent Building Condition Assessment	Referral to Asbestos & Lead Management Program for Independent Asbestos Inspection	Test Fit
101 Ash	No	No	No	No
Civic Center Plaza	Yes	No	No	No
Housing Navigation Center	No	No	No	No
Kearny Mesa Repair Facility	No	No	No	No
Palm Avenue Hotel	Yes	No	No	No

Source: OCA generated based on evaluation of inspection reports and interviews with City staff.

For large real estate acquisitions, the City often did not independently appraise the property and establish the fair market value before completing negotiations.

Per City policy, the City should appraise the real property to be acquired and establish the fair market value before the completion of negotiations. Assessing a building's value and using this value in negotiations ensures that the acquiring entity obtains a price in line with similar buildings in the local real estate market. An appraisal is an estimate of value, not a determination, based on all relevant data. Value is determined in the marketplace as buyers and sellers negotiate actual transactions.

We found that the City did not perform independent appraisals for most of the buildings it purchased, and relied instead on appraisals from the seller and brokers' opinions of value provided by the seller, which are not equivalent to appraisals. This left the City and City Council with insufficient information to effectively determine what the City should be willing to pay for these properties.

Other cities' real estate directors and the City's own principal appraiser noted that appraisals should be conducted by independent, qualified appraisers that appear on the City's approved contractor list. Using an independent appraiser lends transparency and independence to the process. There is value in the City using its own independent appraiser because in acquisitions (purchases or leases), the City is the client and being involved in the process allows the City to understand the approach and information the appraiser used to come to their conclusion on the value of the property. Cities we benchmarked San Diego with noted that they would not rely on the seller's appraisal because the seller's appraisal may not consider the buyer's proposed use of the property and it may not be current to accurately reflect present market value.¹⁵

Additionally, internal real estate staff should have appraisal experience and be qualified to evaluate appraisals received from the City's contractors. READ's principal appraiser stated that the appraisal client (the City) and the appraiser work together

¹⁵ We compared San Diego's real estate policies and practices to those of eight other public entities: the cities of Austin, Phoenix, San Jose, and Seattle; Los Angeles County; San Diego County; the State of California; and the San Diego Association of Governments.

throughout the appraisal process—the client provides documentation and information for the appraiser to consider and the appraiser makes professional judgements on what to include and what may impact the property's value. The City should not rely on the seller's appraisal because it is in the best interest of the City to understand the value of the property and the City should include as much information as possible in the appraisal to get the most accurate estimate of the value of the property. Without working with the appraiser to ensure he or she has all the information, the City cannot ensure the appraisal is accurate for the City's needs.

Brokers' opinions of value are not equivalent to appraisals. Brokers' opinions of value are based on the property records a broker has and can be made without any physical inspection of the building or review of due diligence. Additionally, READ's principal appraiser stated that brokers' opinions of value are not as accurate or valid of a measurement of a building's worth compared to appraisals, as the broker provides this service so they can get the property listing.

The City should also appraise leased properties prior to acquisition. The appraised value can help the City determine if rental rates are within current market rates. It is particularly important to get an appraisal if tenant improvements are planned after the lease commencement. This way, the City will know the appraised value prior to improvement and then after improvement to determine future purchase price. For example, when the City leased the Kearny Mesa Repair Facility, it did not get an appraisal on the property even though the City anticipated \$6.5 million in tenant improvements. Now that the tenant improvement cost has increased to approximately \$14.8 million, the City is poised to make a significant real estate investment in a property that it may never own.

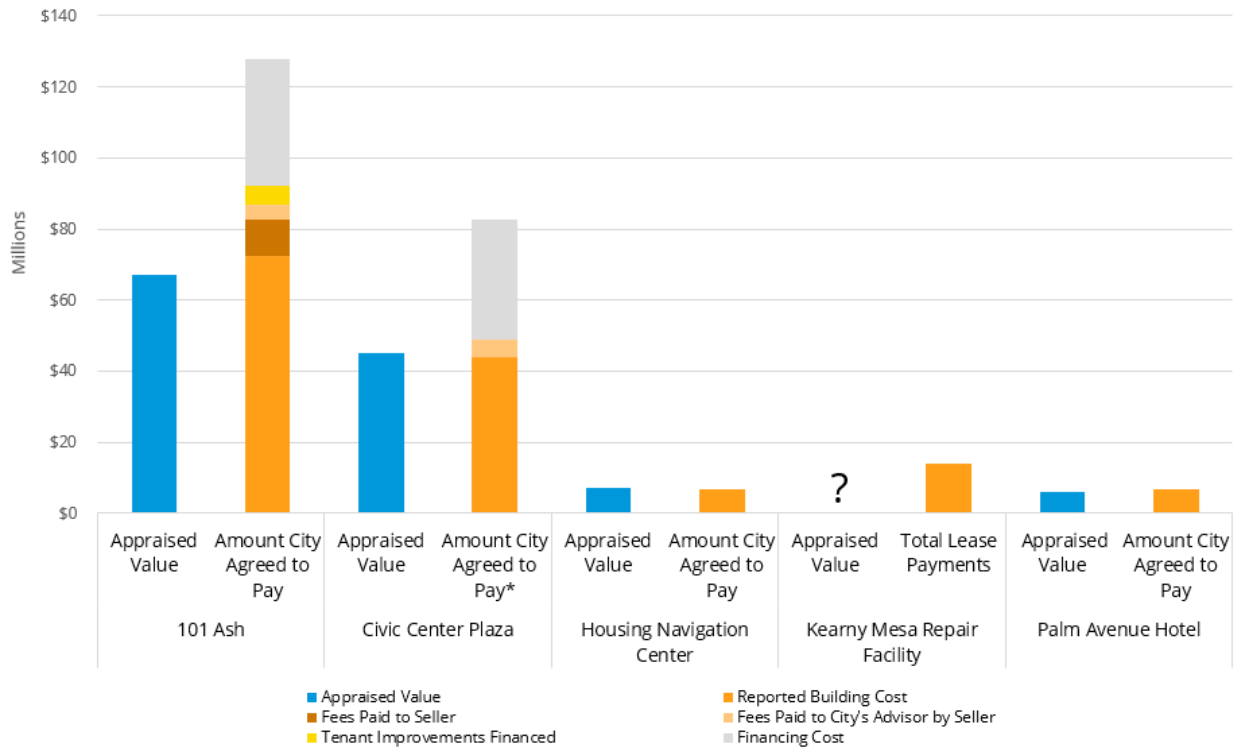
Without an independent appraisal, the City may pay more than the building is worth. Without the aid of an appraisal from an independent appraiser working for the City, the City risks not having a clear value of a property. Additionally, this unclear value can be passed on to City Council.

During the acquisition of 101 Ash, the City relied on a broker's opinion of value and an appraisal commissioned by the seller to support the already agreed-upon purchase price of \$72.5 million. The City did not use these tools in negotiations with the seller. The appraisal valued 101 Ash at \$67.1 million, \$5.4 million lower than the agreed-upon purchase price. The broker's opinion of value valued 101 Ash at \$83 million to \$85 million.

According to an investigative report conducted by Hugo Parker, READ staff used elements of the broker's opinion of value to justify paying higher than the appraised value for 101 Ash. However, Hugo Parker reports that the City actually paid \$92 million for 101 Ash, which includes the tenant improvement loan cost of \$5 million and the \$14.5 million in fees paid to the seller. Ultimately, the City paid 37 percent more than the appraised value of the building—not including interest, operations and maintenance costs, and the actual tenant improvement costs necessary to occupy the building as planned. Had the City used the appraised value only, it could have potentially purchased 101 Ash for a lower price. It also could have considered the value of other buildings in the area and potentially purchased a more expensive building that ultimately needed less remediation and tenant improvements. **Exhibit 14** below shows how the City paid more than the appraised value for most of the acquired buildings in our scope.

Exhibit 14

The City Paid More Than the Appraised Value for Most of the Acquired Buildings



Source: OCA generated based on evaluation of lease agreements, appraisals, and other relevant materials.

The City does not have a policy describing what building condition assessments are necessary and for what situations.

Building condition assessments are another key part of due diligence. They inform a prospective buyer or lessee about a property's condition, suitability for intended use, the need for repairs, and overall value. While the types of assessments vary, a policy governing their type, use, and deployment should be established to ensure that building conditions are assessed prior to building acquisition.¹⁶

Cities we benchmarked with stated that it is incumbent upon the acquiring agency to fully understand the building's condition prior to contract signing to protect the agency's interests. Knowing the building's condition can also help the acquiring

¹⁶ Types of assessments can include environmental, building systems (heating, air cooling, plumbing, electrical), compliance with the Americans with Disabilities Act, hazardous materials, seismic, geotechnical, and fire prevention systems.

agency negotiate more favorable terms. For example, cities we benchmarked with stated that they provided building condition assessments to their appraisers to influence the appraised value of the building and to achieve a better price.

READ did not consistently gather building condition assessments for most of the buildings in our scope. The City does not have a formal policy requiring building condition assessments for proposed building purchases or leases. READ has a department acquisitions checklist that requires a facilities assessment (which includes Americans with Disabilities Act compliance, hazardous materials, asbestos and lead paint assessments), a building systems investigation, and an environmental assessment. However, READ does not consider the checklist mandatory and the City does not have any other guidelines or policies on building condition assessments to conduct before acquiring a building.

Without a clear policy and enforcement, the City gathers building condition assessments inconsistently. Unclear roles contributed to this inconsistency. READ believes that acquiring department are responsible for gathering building condition assessments. Whereas the acquiring departments for the acquisitions in our scope stated that READ was responsible for initiating these assessments and ensuring their completion.

When the City does not perform building condition assessments on a proposed acquisition, the City relies on the seller's documents, which can greatly increase the likelihood of unexpected costs. For example, according to an investigative report, the seller's building condition assessments for 101 Ash that were provided to READ expressly stated that the assessments did not include a review of asbestos in the building. Had READ ordered its own assessments, it could have directed the contractors to include a wider scope. Therefore, READ would have been more informed prior to the lease signing about the extent of asbestos in 101 Ash and the other systems needing repairs. With this information, READ could have negotiated a better price for the building. Furthermore, READ would have had a better idea as to how the extent of the asbestos would affect its planned tenant improvements and associated costs. However,

READ did not conduct such a review until after the lease was signed and now 101 Ash is estimated to require \$115 million in unexpected asbestos abatement costs and other costs to update the condition of the building's systems so that the City can use the building as office space for 1,100 employees as originally intended.

Staff did not conduct asbestos inspections on any of the buildings in our scope prior to purchase or lease. While the City lacks policies and procedures for many elements of due diligence, City guidelines do require an assessment of asbestos before the City purchases or leases a building. The cost of asbestos abatement and upkeep should be used in negotiations and factored into the costs of acquisition and risks of tenant improvements. The City guidelines were originally established in the early 1990s after the City acquired a major property in Hillcrest, and the subsequent discovery of asbestos resulted in the City selling the property at a loss.¹⁷ However, we found that the City Administration no longer enforces these asbestos guidelines, and the City purchased two major buildings that were constructed during an era when asbestos was commonly used without performing inspections to understand the extent of the asbestos in the buildings.

Conducting an asbestos inspection prior to the lease or acquisition of a building is important for several reasons. First, asbestos inspection can help inform the appraisal (and potentially influence the lease or purchase price). According to the City's Asbestos and Lead Management Program (ALMP) policy, property values have decreased due to the presence of asbestos. Second, it can inform the terms and conditions of a proposed lease or purchase agreement. Third, it can prevent potentially expensive and unforeseen renovation costs that involve asbestos removal.

For example, READ did not conduct an asbestos inspection on 101 Ash prior to acquisition and instead relied upon documents

¹⁷ https://docs.sandiego.gov/council_reso_ordinance/rao1987/R-269740.pdf;
https://docs.sandiego.gov/council_reso_ordinance/rao1987/R-269968.pdf;
https://docs.sandiego.gov/council_reso_ordinance/rao1988/R-270227.pdf;
<https://www.latimes.com/archives/la-xpm-1987-12-04-me-17741-story.html>, accessed 6.25.21

provided by the seller. While the seller's documents indicated the presence of asbestos in the building and even noted that a thorough survey should be undertaken when planning renovations, it is unclear whether these disclosures factored into the negotiating price. It is also unclear as to the degree to which the presence of asbestos was even understood by the City when calculating the costs of the building and tenant improvements. While the presence of asbestos itself was not necessarily a problem if the City decided to occupy the property with minimal improvements, it became an issue once the City decided to expand the scope of the tenant improvements and renovate all 19 floors after the City signed the lease-to-own agreement. Because READ did not perform the asbestos inspection and test fit (see next section) prior to purchase, the cost of renovations and subsequent asbestos remediation costs are far higher than expected.

Unclear roles hinder the City's Asbestos and Lead Management Program's involvement in building acquisitions.

According to ALMP staff, READ is responsible for engaging ALMP in acquisitions because READ is the most knowledgeable of the lease or purchase deal. Although ALMP staff indicated they would like to be more involved with building acquisitions early on, they do not have the staff to proactively monitor Council documents for proposed acquisitions on the horizon. However, READ stated that client departments are responsible for obtaining asbestos inspections when needed. As the City's real estate experts and head of due diligence, READ should be the responsible party to engage ALMP to conduct inspections and ensure that the inspection results inform the building's appraisal and contract terms and conditions.

The City does not consistently conduct test fits on buildings prior to acquisition, which can lead to unforeseen and expensive renovation

A test fit is a floor planning exercise to confirm if a tenant's needs can be met. A test fit should be conducted to ensure the building fits the need of the City and to ensure the City has accurate information for the necessary tenant improvements before committing to an investment. We found that the City does not have a policy guiding when to conduct a test fit and that the City does not consistently conduct test fits before acquiring buildings.

costs after the building is acquired.

READ staff did not conduct a test fit for 101 Ash prior to signing the lease-to-own contract. Although READ staff had initially anticipated to move 1,100 employees into 101 Ash at the time of the lease signing, the plan quickly changed once READ hired a consultant to create a space plan (which also included a test fit).¹⁸ The initial plan presented to City Council included renovating only five floors of the building and expected these tenant improvements to cost \$5 million, but this estimate was not based on a test fit or space plan. Once the consultant conducted a test fit, it found the City would need to renovate all 19 floors to maximize the space for 1,100 employees. Expanding the scope of the tenant improvements eventually resulted in an estimated project cost of \$26 million five times the cost initially approved by City Council.

Similarly, the City did not perform a full test fit for the Kearny Mesa Repair Facility prior to signing the lease. Test fits and design costs post lease signing have led to a 128 percent increase over the initial tenant improvement cost of \$6.5 million. Without a full test fit prior to lease signing, City staff have been stuck on how to “value engineer” the design back towards the original estimate of \$6.5 million. In the interim, the property sits as storage and inefficiencies at the existing repair facility for both fire trucks and trash trucks persist.

Performing a test fit prior to acquisition is prudent and may save the City money in the long run. Additionally, having a clear objective for the intended use of the property and how the property will meet the needs of the intended occupants will help mitigate unforeseen tenant improvement costs in the long run.

Presenting due diligence to City Council also helps to ensure transparency in the acquisition process. The City does not have a policy stating what due diligence should be presented to City Council during a building acquisition. As a result, we found that none of the due diligence documents the City obtained were

¹⁸ A space plan is a detailed, in-depth look at the space, including circulation patterns and layouts for furniture and equipment. The difference between a test fit and a space plan is the level of thorough detail.

made available to City Council and the public for review at the time of presentation. Had City Council had access to the due diligence documents, they would have had the ability to question some of staff's assumptions about the properties. For example, City Council would have had the opportunity to review the appraisal for the Housing Navigation Center and perhaps question why the valuation was based on its designation and income as a skydiving center (when the center was intended to be used for homeless services). City Council would have had the opportunity to request an independent appraisal to obtain an accurate valuation of the building prior to acquisition.

The benchmarking agencies we spoke with often used a checklist to account for the due diligence performed during the acquisition process. Some agencies indicated they presented elements of the checklist such as notification that all due diligence has been completed, acquisition terms, and how the acquisition fits into the strategic plan to their oversight bodies. A checklist can help ensure that READ conducts all required due diligence. Additionally, presentation of this checklist to City Council, along with the due diligence documents, will increase transparency in the acquisition process and allow City Council to make more informed decisions.

Recommendation:

To ensure the City understands the full condition of buildings in future acquisitions, we make the following recommendation to ensure that READ conducts key elements of due diligence:

Recommendation 5

We recommend that the Real Estate Assets Department (READ) create a due diligence checklist in an Administrative Regulation to ensure that the due diligence items (as recommended in Recommendation 1f) are accounted for prior to purchase and presentation to a designated oversight committee. READ should be responsible for completing this checklist, and if READ determines an item is unnecessary for a particular acquisition, READ should be responsible for reporting with supporting information why READ chose not to complete the required item. The checklist should include, but is not limited to, the following items:

- a. **Independent Appraisals.** READ should contract for an appraisal for the building early in the negotiations on

purchase price, before the purchase price is agreed upon.

- b. **Independent Building Condition Assessments.** READ should create a policy on what assessments (e.g., facilities, systems, hazardous materials, ADA, plumbing, geotechnical, etc.) are required and when and who is responsible for ensuring they are conducted.
- c. **Environmental Assessment.** READ should hire a contractor and/or have qualified City staff perform a Phase 1 environmental assessment.
- d. **Independent Asbestos Assessment.** READ should engage the Asbestos and Lead Management Program to determine if an asbestos inspection is necessary before entering into a purchase and sale agreement. Asbestos inspection conclusions should be considered in the building's negotiated purchase price and/or for future tenant improvements.
- e. **Test fit.** READ should create a policy on when a test fit is required and when and who is responsible for ensuring it is completed and included in the tenant improvement cost and cost/benefit analysis. (Priority 1)

Finding 3: The prior City Administration diminished City Council's oversight capabilities on major real estate acquisitions by failing to provide complete and accurate information.

As described in Findings 1 and 2, the vast majority of steps required to successfully execute major building acquisitions should be carried out by the City Administration. However, under the Strong Mayor form of government, the City Council fills an essential oversight role by reviewing the Administration's decision-making and approving or denying the Mayor's proposals, such as for major building acquisitions. A significant risk is that the City Administration may not provide sufficient information to enable the City Council to serve as an effective check and balance, and may present selective or inaccurate information to gain City Council's support for the Mayor's proposals.¹⁹

We found that the City needs to significantly improve controls to mitigate this risk and increase City Council's ability to provide effective oversight of the Mayor's major building acquisition proposals. Specifically, we found that City staff did not provide the City Council with complete and accurate information about transactions, and the Office of the Independent Budget Analyst was not provided the time, information, or resources to perform comprehensive analyses to assist City Council's decision-making. The following sections discuss these issues in more detail.

¹⁹ For example, this risk was highlighted in a 2005 RAND Corporation report that was commissioned by proponents of Proposition F, a November 2004 ballot measure approved by voters that transitioned the City to a Strong Mayor form of government effective January 1, 2006.

https://www.rand.org/content/dam/rand/pubs/monographs/2005/RAND_MG411.pdf

The prior City Administration did not inform City Council and the public of all material facts on 101 Ash and the Housing Navigation Center.

City Council's ability to weigh the costs and risks of the acquisitions against the benefits presented by City staff was likely hindered by a lack of material information. This lack of information may have diminished City Council's depth of oversight when committing more than \$230 million of public funds to acquire buildings whose reported benefits have largely failed to materialize.

The San Diego City Charter sets out City Council as the City's legislative branch, which includes approving the City's annual budget, authorizing the issuance of general obligation and revenue bonds, and overseeing City contracts, such as leases and acquisitions. For City Council to fulfill these duties, the City Charter requires the Mayor and City staff to inform City Council of "all material facts or significant developments relating to all matters under the jurisdiction of the Council." City Council needs all material information to make decisions in the best interest of the City on major real estate investments. However, when proposing the acquisitions of the 101 Ash Street building and the Housing Navigation Center, City staff did not include material information and misrepresented information in the staff reports or presentations to City Council.

READ misrepresented the condition of 101 Ash. City staff at the time told City Council that the 101 Ash Street building was a Class A building. Staff also told City Council that the City got a property condition assessment report that showed 101 Ash was in excellent condition and the only immediate need was a \$10,000 exterior power washing and caulking. However, the appraisal for 101 Ash that City staff relied on at the time stated that “even in a rehabilitated condition, the subject property will always be a Class B building.” The appraisal and the property condition report the City relied on both state the building is in good condition, not excellent. City staff did not inform City Council that the City relied on the building condition assessment provided by the seller rather than conducting its own, independent, building condition assessment.

The building condition assessment READ relied on did not test the condition of key components of the building, such as the heating, ventilation, and air conditioning (HVAC); fire protection; or electrical systems.

The City finally contracted for its own building condition assessment of 101 Ash in 2020, three years after acquiring the building. That assessment estimates the building needs an additional \$115.2 million in improvements—far more than the originally reported \$10,000.²⁰ The assessment found several major issues with the condition of the building, detailed in **Exhibit 15**. The \$115.2

Exhibit 15:

101 Ash Building Condition

Presented by City staff at the time of purchase:

- Building is Class A
- Building only needs exterior power washing and caulking
- Total estimated cost of \$10,000

What staff knew at the time of purchase:

- Building is Class B
- Building has asbestos that could impact major renovations
- City had not done an assessment to know what condition the building was in and what repairs may be necessary

Building needs found by City consultants after acquisition:

- HVAC system should be replaced
- Asbestos-containing materials should be removed from visible and accessible areas
- Fire safety issues critical to the safe occupation of the building should be addressed
- Issues with the piping, electrical, and other systems should be addressed
- Total estimated cost of \$115.2 million

Source: OCA generated based on review of City staff reports and consultant investigative reports.

²⁰ The building condition assessment the City contracted for was conducted in 2020, four years after the City reviewed documents and proposed buying the building. The condition assessment was also

million cost to address these issues does not include changes to layout and office space for the City to occupy the building. The \$115.2 million cost also does not include anticipated future costs, such as replacing the elevator systems, or voluntary upgrade costs, such as increased earthquake performance for a rare event.

READ did not clearly state the cost of purchasing 101 Ash.

The City's staff report to City Council stated that the "City is now able to lease-to-own the building based upon [the seller's] purchase price of \$72.5 million." When comparing the cost to lease 101 Ash to the market rate, the staff report used the purchase price of \$72.5 million. The cost comparison in the staff report compared the \$72.5 million purchase price to the \$67.1 million appraised value of the building. However, the appraisal stated that the \$67.1 million value of the building was based on the assumed value of the building once the City invested the \$5 million in tenant improvements. Based on that alone, the City's comparison costs to purchase the building should have started at \$77.5 million to make it clear that the City was paying at least \$10.4 million more than the appraised value.

Further, the staff report did not make the true cost of the building clear in the cost comparison section. Through the lease-to-own structure, the City is not just paying \$72.5 million plus interest and operations cost, as would be expected with comparative acquisitions. According to Hugo Parker, because of the lease-to-own agreement, the City is paying \$92 million for 101 Ash.²¹ In addition to the building cost of \$72.5 million, the City is paying \$5 million in tenant improvements, financed through the seller, and \$14.5 million in fees to the seller.

conducted after 101 Ash had undergone renovations by City contractors. The estimated \$115 million includes \$26 million in estimated asbestos abatement and ceiling replacement costs. These building improvements may not have been necessary in 2016 when the City was considering purchasing the building. The rest of the costs may or may not have existed in 2016, but the City did not have independent condition reports that looked at those areas.

²¹ In 2020, the City contracted with Hugo Parker, LLP to review the 101 Ash transaction. The publicly released version of the report can be found here: https://onbase.sandiego.gov/OnBaseAgendaOnline/Documents/ViewDocument/Att.%201_%20%20Forensic%20Review_Preliminary%20Report%20on%20101%20Ash%20Street%20_PUBLIC_July%202020.pdf?meetingId=4099&documentType=Agenda&itemId=191555&publishId=406740&isSection=false

Therefore, the comparison cost for acquiring the building should have made clear to City Council that the prior City Administration was proposing to pay \$92 million for a building with an appraised value of \$67.1 million. Emails from the seller to READ include information about the seller's fees and the financing cost that indicated the seller planned to include all of these costs into the lease payments for the building.

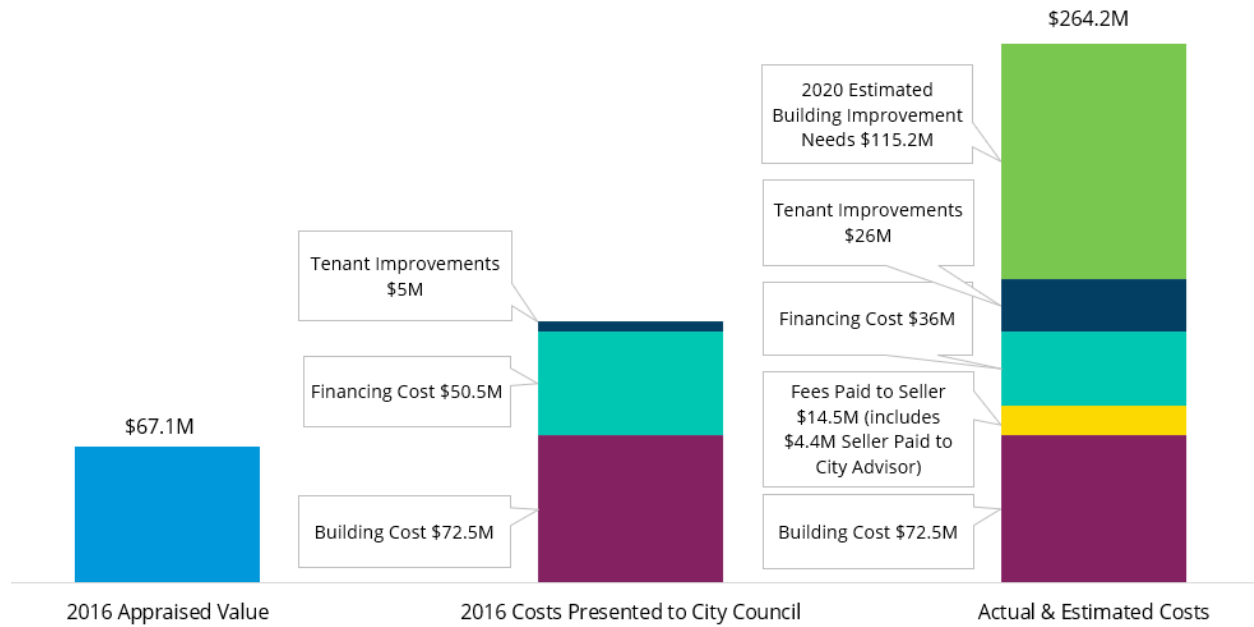
As mentioned, READ also did not include an accurate estimate of tenant improvement costs or building condition improvements necessary. As shown in **Exhibit 16**, READ told City Council that the City was purchasing 101 Ash for \$72.5 million, plus \$5 million in tenant improvements. READ also stated that the City would pay \$6.4 million in lease payments annually for the building, which totals \$128 million over the 20 years of the lease-to-own agreement. READ did not clarify what went into the \$128 million total beyond the \$72.5 million for the building, but **Exhibit 16** illustrates this difference as "financing costs."

Now, as shown in **Exhibit 16**, the City is currently estimated to need to pay a total of \$264 million to occupy the building as intended. Part of the financing costs READ did not detail to City Council include \$14.5 million in fees paid to the seller. Tenant improvement costs totaled \$26 million, not \$5 million. The building now needs an estimated \$115 million in building improvements, not a \$10,000 power wash.

In total, the City Administration was proposing paying \$92 million, plus financing costs over 20 years, for a building then appraised at \$67.1 million. This would not include operating costs. In addition, the City Administration did not know and did not inform City Council that the total cost may rise to an estimated \$264 million in total.

Exhibit 16:

READ Told City Council It Would Cost \$128 Million Over 20 Years to Occupy 101 Ash While Estimated Costs Now Total \$264.2 Million



Source: OCA generated based on review of staff reports to City Council, City Council meetings, and investigative reports on 101 Ash.

To be clear, the staff report did include the total cost of the building over the 20-year lease—but READ often presented it in terms of the annual cost of \$6.4 million or \$1.70 per square foot per month. The staff report and presentation also discussed operations costs and tenant improvement costs at the same time, so it was not clear what staff included in the \$1.70 per square foot per month cost and what staff did not.

For example, when READ presented to City Council to approve the acquisition of 101 Ash, a councilmember asked why the Independent Budget Analyst's (IBA) report said the total cost was \$207.1 million, while the staff report said \$201 million.²² IBA staff stated that their report was including the \$5 million in tenant improvement costs in their calculation, but City staff's report did not include the \$5 million because the \$5 million was provided

²² The total \$201 million and \$207.1 million costs include both the total lease payments for 101 Ash and the estimated operations costs, which are not paid to the seller.

by the seller, and City staff did not correct the IBA's assessment. On multiple occasions, City staff appeared to represent that the \$5 million in tenant improvements was provided by the seller for free as part of the lease-to-own deal, while in actuality the seller was simply loaning the City the \$5 million in tenant improvements and rolled that cost into the monthly rent for the building.

READ did not clarify the difficulty in refinancing the 101 Ash lease-to-own terms. The lease-to-own agreement allows the City to purchase the building outright from the seller after five years at a specific rate. The IBA's report at the time of acquisition stated that because of the terms of this provision, it is unlikely this provision would actually be financially beneficial to the City. However, when a councilmember asked if READ would be willing to come back in five years to consider purchasing the building to potentially save the City money, READ said yes and did not mention that refinancing or purchasing the building in line with the terms of the agreement was unlikely.

In August 2020, the City asked a real estate consultant to look into options to refinance the building. The consultant stated it would be next to impossible to refinance the building under the terms of the lease. The cost the City would have to pay the landlord would still be very high. Additionally, the consultant's report notes that the contract requires the City give irrevocable 90-day notice of refinancing, despite a bond market that may fluctuate within those 90 days and cost the City more than it was planning to pay.

The prior City Administration did not clarify the reasons why it was not proposing to purchase 101 Ash directly.

The IBA reported at the time that the City could have saved \$17.2 million had the City been able to purchase 101 Ash from the seller using lease-revenue bonds rather than through a lease-to-own agreement. The City Administration reported that the City could not purchase 101 Ash using lease-revenue bonds for a number of reasons, including (1) unclear legal language in the purchase and sale agreement between the company selling 101 Ash to the City and the owners of 101 Ash at the time, and (2) not being able to get the bond financing together in time. However, we found issues with these assumptions that were not

presented to City Council, and the omission of this information was potentially very costly to the City, specifically:

- 1) The City Administration at the time said that the City had to acquire 101 Ash through a lease-to-own agreement because the legal language in the purchase and sale agreement between the company selling 101 Ash to the City and the owners of 101 Ash at the time put the City at risk of being sued. The company selling 101 Ash to the City was purchasing 101 Ash from 101 Ash's owners at the time and then immediately selling the building to the City. To arrange this transaction, the company selling to the City had a purchase and sale agreement with the owners of 101 Ash and the company selling to the City told the City they planned to assign that purchase and sale agreement to the City, so the City could effectively buy the building directly using lease-revenue bonds.

However, the City Administration reported that the purchase and sale agreement between the company selling to the City and the owners of 101 Ash at the time was not clear on whether or not the company selling to the City could assign the purchase and sale agreement to the City. Assigning the purchase and sale agreement to the City would mean the City would in effect be buying the property from the owners for the same price the company selling it to the City was buying it for—avoiding the lease-to-own terms and the profit paid to the seller.

This concern about unclear language could have been resolved had the company selling 101 Ash to the City agreed to clarify the language in the purchase and sale agreement or agreed to seek written consent to assign the agreement to the City. According to READ, the company selling it to the City refused to do either.

What staff did not make clear to City Council was that the company selling 101 Ash to the City allegedly had initially agreed to assign the agreement to the City with zero profit to themselves. According to staff, the seller was going to assign the agreement as a "good will gesture towards the City." Staff said "of course, the Plan B was always a lease-to-own, so they were waiting in the wings

to accept a profit should the lease-to-own arrangement become necessary (which it did).”

At the end of the day, the seller’s refusal to clarify the language necessitated the lease-to-own arrangement. The seller charged the City \$14.5 million (20 percent) in fees and made a profit on the arrangement.²³ City staff dealing with the seller knew the seller had profited from a lease-to-own deal with the City before—the City paid the same seller a 10 percent profit when the City leased-to-own the Civic Center Plaza building from the seller. City staff should have been skeptical of the seller when they allegedly were planning to forgo profit to do the City a favor. The City Administration should have made it clear to City Council that the City would be paying more for the building in a 20-year arrangement because the seller refused to clarify the language and, in refusing to clarify the language, put themselves in a position to make a profit.

- 2) City staff also represented that bonds would not have worked with the unclear purchase and sale agreement language and timing concerns, but that does not appear to be accurate. As mentioned above, the IBA reported at the time that the City would save \$17.2 million if it could buy 101 Ash with bonds rather than through the lease-to-own arrangement. In City Council meetings, when asked by multiple councilmembers why the City could not save the estimated \$17.2 million and buy 101 Ash directly, City staff cited the unclear language in the purchase and sale agreement. However, the Deputy Chief Operating Officer overseeing READ at the time also stated that they would not be able to raise bond financing to meet the seller’s deadline, and if the City did issue the bonds without clear language, there was a risk the City would be sitting on a bond issuance without a building if the owner sued the City and the seller over the unclear purchase and sale agreement language.

However, according to the Chief Finance Officer at the time and Debt Management Department Director, the

²³ \$14.5 million is 20 percent of the building’s reported cost of \$72.5 million.

City could have purchased 101 Ash with bonds within the time constraints. City staff were so confident the City could have purchased 101 Ash with bonds that staff had docketed a staff report to go to City Council for approval of the bond issuance. Additionally, the Debt Management Department Director stated that being left without a building was not a risk, as staff had included a contingency in the ordinance for the City to use the bond's funds for alternative City infrastructure needs if the 101 Ash acquisition did not close. However, the City Administration decided not to finance the building with bonds and only presented City Council with the lease-to-own option instead.

We cannot state conclusively why the City Administration chose to move forward with the lease-to-own arrangement and to represent to City Council that purchasing with bonds was not an option. As detailed in the Objectives, Scope, and Methodology, we interviewed several former City staff members involved in this transaction, but the Mayor, READ Director, Deputy Chief Operating Officer overseeing READ at the time, and the advisor did not agree to interviews for this report.

READ and the City Attorney's Office did not disclose the risks of the 101 Ash lease-to-own contract to City Council.

As detailed in Finding 1, the lease-to-own contract to acquire the building from the seller presented notable risks. Acquiring the building from the seller, who never occupied the building, meant that the City had little assurance the seller would know and disclose the condition of the building. The contract also had a clause where the City agreed to accept the property "AS IS," knowing all of its defects. Taken together, these contract elements mean the City may have little recourse if the City finds significant and costly defects with the building. These risks may have been acceptable with a thorough understanding of the building's condition and sufficient due diligence, but these are substantial risks that may have been helpful in City Council deliberations to determine if 101 Ash was a worthwhile investment of City funds. We did not find any evidence that READ or the City Attorney's Office disclosed these legal risks to councilmembers.

READ did not disclose its incomplete understanding of 101 Ash's condition and lack of due diligence. Compounding the risk presented in the 101 Ash lease-to-own contract, READ also did not disclose to City Council the lack of information staff gathered to understand the condition of the building. READ relied on an appraisal, building condition assessments, and other documents provided by the seller. READ used these documents to present information to City Council, including the value of the building and the amount it would cost for the City to house 1,100 staff into the building. As stated earlier in this finding, staff's report on the condition of the building relied on assessments that did not test the condition of key components of the building, such as the HVAC, fire protection, or electrical systems. In 2020, the City's contractor estimated costs to address issues with these systems would cost more than \$88 million—significantly more than the \$10,000 caulking and power wash READ reported in 2016. READ did not disclose to City Council that it relied on the seller's building information and did not conduct its own building condition assessments in line with best practices. This information was material information that City Council would likely have used in their deliberations on the acquisition.

For the Housing Navigation Center, READ relied on the seller's appraisal of the building as an indoor skydiving facility. In the City Council meeting to approve the purchase of the indoor skydiving center at 1401 Imperial Ave to use as a Housing Navigation Center, READ and City Council emphasized what a great deal this acquisition was for the City since the City was acquiring the building for "way below market value." The staff report stated that the property had an appraised value between \$15 million and \$22 million, but the City was buying the building for \$7 million. When asked why the seller would sell the building for less than half its value, READ said the seller was an "altruistic widow" who expected to write off the difference on her income taxes.

READ did not disclose to City Council that staff relied on documents provided by the seller and did not conduct its own appraisal, instead presenting valuation information based on the building's use as an indoor skydiving center. When asked directly

by a councilmember about the appraisal, the READ Director at the time did not disclose that the appraisal was provided by the seller. The councilmember asked when the City was going to conduct full inspections on the building and the READ Director at the time said the inspections had already occurred—although the City had not conducted any of its own independent building condition assessments. This material information would have been important for City Council to consider when considering City investment.

The City does not have an enforcement mechanism in its municipal code to take action if City staff do not provide all material facts to City Council.

As mentioned above, the City Charter requires that the Mayor and City staff inform City Council of “all material facts or significant developments relating to all matters under the jurisdiction of the Council.” However, the City has few enforcement mechanisms to ensure City staff meet this requirement. The City Attorney’s Office stated that the City can terminate an employee for violating this section of the City Charter, but that leaves little recourse for City Council if the employee violating the section is acting on behalf of the City Administration, as the City Administration could choose to not terminate the employee. The requirement in City Charter should have a corollary enforcement mechanism in the San Diego Municipal Code that can be acted upon in the event City staff fail to provide all material facts or significant developments to City Council.

To be clear, we do not know why City staff did not provide City Council with all material facts relating to the building acquisitions, as detailed above. Two staff members made most of the presentations: the READ Director at the time and the Deputy Chief Operating Officer overseeing READ at the time. Both staff members were overseen by the Mayor at the time. We reached out multiple times to the READ Director at the time and the Deputy Chief Operating Officer overseeing READ at the time, but neither party made themselves available for an interview within the timeframe of this audit. We interviewed the Mayor’s Chief of Staff at the time, however, the Mayor at the time did not agree to a timely interview.

The prior City Administration's lack of planning and crunched timelines on nearly every deal we reviewed minimized the time City Council and its oversight mechanisms had to evaluate these building acquisitions.

City staff should provide the Independent Budget Analyst's Office (IBA) and City Council committees with timely, thorough, and accurate information to fulfill their obligations to City Council. Without sufficient time and information to review the complex building acquisitions City staff propose to City Council, the IBA cannot fulfill its role in providing City Council with an independent economic analysis of the transaction. Without City Council committee review, City proposals are not presented to the public for input and questions prior to City Council's first vote on the acquisition. The Smart Growth and Land Use Committee at the time of these acquisitions was responsible for overseeing the City's real estate assets.²⁴ Without the IBA's analysis and input from the public through a City Council committee, City Council relies solely on the information provided by City staff and may have to vote on the proposal before staff gather information to respond to key questions on the transaction. As discussed in this report, the information provided by staff is not always complete and is not always accurate.

When the City acquired Civic Center Plaza, according to the IBA, City staff gave City Council and the IBA just four days to review the details of the transaction despite having had 23 years' notice the lease was expiring. City staff provided City Council and the IBA the staff report on the acquisition and backup materials on January 22, 2015—four days before City Council had to vote on the 20-year \$83 million investment. The IBA's report on the transaction said that this timeline did not allow City Council sufficient time to fully vet the item, request additional information, or suggest modifications. READ's staff report presented no true alternatives to leasing-to-own Civic Center Plaza, instead, as the IBA pointed out, staff emphasized the significantly increased costs to continue to lease downtown office space if City Council did not immediately approve this high-stakes contract.

READ stressed that it rushed the Civic Center Plaza acquisition because of the timeline set by the seller. However, the City has occupied the building since 1991 and had 23 years' notice that its lease was expiring in July 2014. Although purchase of Civic

²⁴ The committee is now called the Land Use and Housing Committee.

Center Plaza may have been the optimal choice, there is no evidence in the information presented to City Council on Civic Center Plaza that READ staff were pursuing other office space lease options during this time. Additionally, READ initially presented the acquisition as a purchase using bond revenues in a November 2014 City Council closed session. When City staff came back to City Council with the acquisition in January 2015, the entire structure of the deal had changed because the City could not use bonds due to an ongoing lawsuit and the deal was therefore presented as a lease-to-own acquisition. As discussed throughout this report, lease-to-own acquisitions are complex and come with increased risk. Staff created the lease-to-own option in a compressed timeline and staff passed that compressed timeline on to City Council and the IBA with no viable alternatives presented for consideration.

In the City Council meeting to acquire Civic Center Plaza, multiple councilmembers expressed their frustration with the lack of time to review the proposed major acquisition and the lack of viable alternatives. One councilmember stated, "As a practical matter, we don't have any other choices today." Another councilmember stated, "Time and time again I remember seeing things come very last minute requesting the Council to act quickly and if we didn't act the world was going to come to an end. I hope that's not the same thing we're going to start seeing here." The READ Director at the time responded to councilmembers' concerns stating, "to not give you adequate time to review does not work to anybody's benefit and we do not plan to do that going forward." However, City staff continued to bring items to City Council on a compressed timeframe with limited viable alternatives.

City staff rushed the 101 Ash lease-to-own acquisition at the end and based it off the very rushed and little-reviewed CCP lease-to-own acquisition. For the 101 Ash acquisition, City Management had planned to acquire the building using bond revenues up until September 7, 2016, and had conducted negotiations and building condition research up until that point under the assumption of a deal structured as a purchase using bonds. However, on September 7, 2016, staff decided to restructure the entire acquisition as a lease-to-own agreement

and present that to the Smart Growth and Land Use City Council Committee by September 21, 2016. This gave City staff less than two weeks to conduct any additional research necessary to mitigate risk to the City presented by the much more complicated structure and to have staff review additional economic analyses on the cost to the City compared to alternative office space. City staff appeared to base much of the 101 Ash lease-to-own transaction on the Civic Center Plaza transaction which, as mentioned above, was a very rushed transaction itself that gave City Council and the IBA very little opportunity to provide oversight. Indeed, the IBA's rushed report on 101 Ash did not include the total \$92 million purchase price even though READ appears to have known the final purchase price. The IBA stated that READ and the City Administration at the time did not inform them of the true price of the building.

Although staff did provide the lease-to-own acquisition to City Council committee and did provide information for IBA oversight, staff highlighted to City Council the need to approve the 101 Ash deal the day it was presented or face very high costs. The READ Director at the time even brought up the seller to tell City Council that any changes to the deal or failure to approve the deal could jeopardize the transaction and any savings to the City. The READ Director at the time did not provide City Council with detailed, researched alternatives for office space to consider. This high-stakes ultimatum again left little room for City Council to provide effective oversight or to ask questions and request additional information, materials, and modifications.

For the Housing Navigation Center, City staff repeated a similar pattern of skipping committee and presenting a compressed timeline with high stakes. City staff did not take the acquisition proposal to any City Council committee for their review and oversight because City staff had agreed to a compressed timeline imposed by the seller. Again, City staff told City Council that if the City did not approve the acquisition that day, the City could face paying between \$15 million and \$20 million for the property. Again, the only alternative City staff provided to City Council was likely paying substantially increased costs if the proposal was not approved.

For the Kearny Mesa Repair Facility, the City took the lease through one committee and later another. City staff took the long-term lease to the Smart Growth and Land Use Committee and then to City Council. However, City Council approved the lease on the consent agenda in both meetings and staff's proposed tenant improvement costs turned out to be significantly inaccurate. Two years after City Council approved the original lease, City staff proposed extending the lease from 10 years to 15 years with an additional 5-year renewal option. However, this lease extension was presented to the Active Transportation and Infrastructure Committee, rather than to the Smart Growth and Land Use Committee, which would have had expertise in the transaction after overseeing the original lease and overseeing the City's land use.

For the Palm Avenue Hotel, City staff did not present the transaction as a high-stakes transaction that must be approved that day without Council follow-up questions, modifications, or delay. However, City staff did not present the acquisition for approval at the Smart Growth and Land Use Committee for their layer of expertise and oversight in the City's land use. Instead staff presented the acquisition to the Public Safety and Livable Neighborhoods Committee.

As highlighted through each of the buildings in our scope, City staff do not consistently present land use and acquisition questions to a dedicated City Council committee with expertise in the City's real estate needs and practices. City Council committees heighten City Council's ability to review closely and deliberate items within City Council's jurisdiction, to fulfill their legislative role and ensure the City wisely invests its taxpayer funds.

Recommendations:

To increase the City Council's ability to provide effective oversight of the Mayor's major building acquisition proposals, we make the following recommendations:

Recommendation 6

We recommend that the Council Policy set out in Recommendation 1 also require that the Real Estate Assets Department (READ) or the acquisition lead present the best

practices checklist to City Council and demonstrate that all pertinent departments have signed off on all aspects of the acquisition process. The due diligence supporting materials, including those listed in Recommendation 4, must also be made available to City Councilmembers and the public. (Priority 1)

Recommendation 7

We recommend that the Independent Budget Analyst, in consultation with the City Attorney's Office, create and bring forward to City Council for approval a section to be added to the San Diego Municipal Code to provide an enforcement mechanism for Charter Section 32.1, to ensure that City staff accurately represent and inform City Council of all material facts or significant developments relating to real estate acquisitions under the jurisdiction of City Council. (Priority 2)

Recommendation 8

We recommend that the Council Policy set out in Recommendation 1 require the Independent Budget Analyst (IBA) to review the best practices checklist before City staff present the checklist to City Council committee and determine if staff completed the steps outlined in Recommendation 1. The IBA's assessment should be conducted in writing and presented with sufficient time for City Council to review its conclusions. (Priority 1)

Recommendation 9

If determined to be necessary, we recommend that the Independent Budget Analyst (IBA) consider requesting budget approval from City Council for an as-needed consultant contract to assist the IBA in reviewing the City's best practices set out in Recommendation 1. The consultant could evaluate whether the checklist itself is fully developed and appropriate. The consultant could also evaluate proposed acquisitions and how well the City completed the checklist with regard to specific future acquisitions. (Priority 2)

Recommendation 10

We recommend that the Council Policy set out in Recommendation 1 require the Real Estate Assets Department (READ) to take all building purchases and leases that require City Council approval to the same City Council committee identified and designated in Recommendation 1. The Council Policy should also require that if the acquisition is not taken to the committee overseeing acquisitions, the City Administration should explain in

writing why and the action taken by City Council should include an express waiver. (Priority 2)

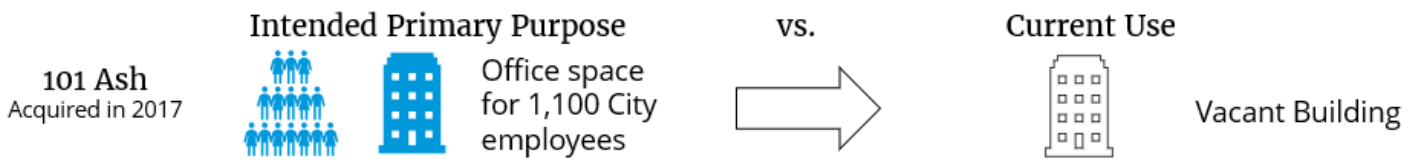
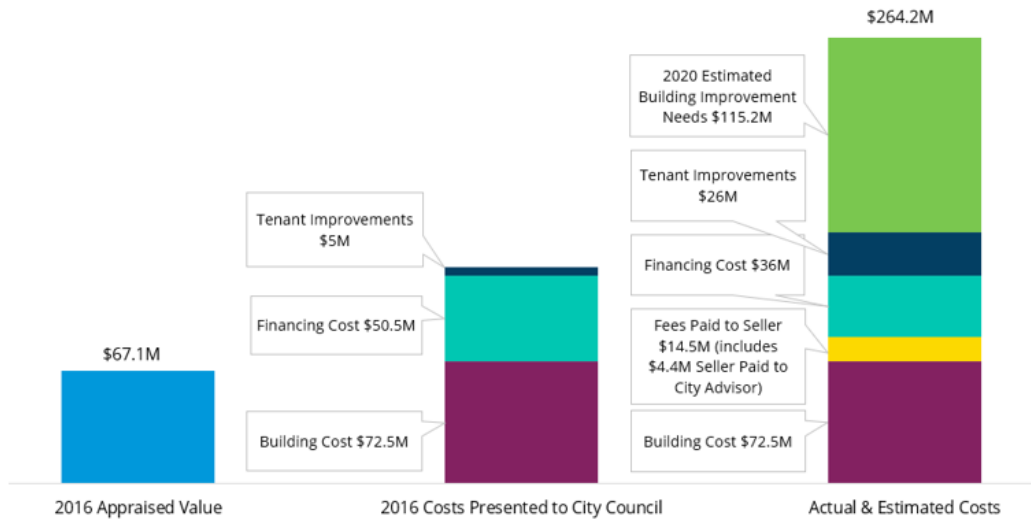
Appendix A: What Happened on the 101 Ash Street Building Acquisition?



Key Issues

- The prior City Administration agreed to a lease-to-own contract that was not favorable to the City. The City agreed to taking on the building as is with limited recourse if the building was not in condition to use as intended.
- The Real Estate Assets Department (READ) did not perform its own due diligence to understand the condition of the building and instead relied on information provided by the seller. READ told City Council that the building was in excellent condition and only needed minor improvements.
- Once the City conducted its own building condition assessments after purchasing the building and investing in tenant improvements, it found the building needs an estimated \$115 million in additional work and is not in excellent condition.
- The prior City Administration and the City Attorney's Office did not present the legal risks of the contract to City Council.
- READ did not clearly report the cost of the building to City Council. READ stated to City Council that the City was paying \$72.5 million, while the City was actually paying \$92 million. The building's appraised value at the time was \$67.1 million.
- The City could have reportedly paid \$17 million less had it purchased the building directly rather than leasing-to-own, but City staff capitulated when the seller refused to clarify language that would have allowed a direct purchase. City staff did not inform City Council that by refusing to clarify the language, the seller stood to make a significant profit.
- READ did not perform a test fit prior to purchasing the building and told City Council that 101 Ash could fit 1,100 employees with just \$5 million in tenant improvements. The building needed \$26 million in tenant improvements to use it as intended.
- READ did not report all material information on the 101 Ash acquisition to City Council, and in the City Council meeting said they had to agree to the purchase that day or risk substantially increased costs to the City.
- The City used a real estate advisor to consult on the acquisition, without gathering any disclosures on the advisor's economic interests or ensuring the advisor acted in the City's best interest. The advisor was then paid \$4.4 million by the building's seller.
- READ estimated the City could occupy the building in July 2017. The building sits vacant today.

READ Told City Council It Would Cost \$128 Million Over 20 Years to Occupy 101 Ash While Estimated Costs Now Total \$264.2 Million



Strategic Plan

READ's Portfolio Management Plans (PMPs) contain READ's high-level goals to plan for future City occupancy costs in owned and leased space and to centralize City functions throughout San Diego. However, the PMPs do not contain specific plans on how READ intends to execute these goals. For example, the PMP does not identify the need to purchase office buildings downtown to house specific departments.

Business Case

Establishing and presenting a business case to READ or an oversight body for a property acquisition can help ensure that a property is used for its intended purpose. For 101 Ash, READ gave several reasons for seeking a new building for office space. READ staff stated to City Council that it sought to purchase an office building because of high deferred maintenance costs for currently owned City buildings, dwindling availability of buildings, and increasing square footage costs in City-leased buildings. Additionally, READ identified 101 Ash as an opportunity to centralize City operations into one building, relocate the Development Services Department from the City Operations Building, substantially improve working conditions for employees, and increase accessibility and ease of flow for the public. Lastly, READ identified 101 Ash as a Class A building that would need only \$10,000 in repair costs to clean, caulk, and pressure wash the exterior of the building. (Although, as detailed further below, we found that his information was not accurate.)

Roles & Responsibilities

The City does not have a clear decisionmaker within the administration responsible for leading acquisition decisions, making responsibilities unclear and allowing essential information to be decentralized or simply not obtained. The acquiring departments often reported that they made some of the decisions, such as funding or tenant improvements, but that READ or others were responsible for some of the decisions. For 101 Ash, staff reported the acquiring department as "the whole City," and stated that there was no lead decisionmaker beyond the Mayor. Based on our interviews, the roles for the acquisition of 101 Ash played out in the following ways:

- The Mayor's Office was the primary acquisition decisionmaker for 101 Ash.
- READ was responsible for conducting all due diligence on 101 Ash prior to acquisition. READ did not perform sufficient due diligence to understand the condition of the building.
- The City used an unpaid real estate advisor to consult on the acquisition, without gathering any disclosures on the advisor's economic interests or ensuring the advisor acted in the City's best interest. According to the City Attorney's Office, the advisor was then paid \$4.4 million by the building's seller.
- The Debt Management Department was responsible for evaluating the City's financing options for 101 Ash. The Debt Management Department evaluated the financing options and confirmed that the City could use lease-revenue bonds to directly purchase 101 Ash, although the prior City Administration decided to pursue a lease-to-own agreement.
- The City Attorney's Office was responsible for performing the legal review of the 101 Ash lease-to-own agreement. The staff report to City Council did not disclose the increased risks of the lease-to-own agreement that contained an as-is clause and how those risks might have been mitigated with the City's performance of its own due diligence.

Economic Analysis

The economic analysis presented to City Council in the staff report stated that the City was obtaining the seller's purchase price of \$72.5 million for 101 Ash. Additionally, the staff report noted that the City would receive \$5 million in tenant improvements from seller. Although the staff report stated that the direct

purchase option was not available, the City still stood to save money in leasing costs over a 20-year period with the lease-to-own option. The staff report compared the savings of leasing-to-own 101 Ash over continuing to lease the Executive Complex building and beginning a new lease with 110 Plaza, a local downtown office building. The staff report did not compare the costs of 101 Ash to other direct purchases.

However, a retrospective report on the 101 Ash acquisition found that the City's true purchase price for 101 Ash was about \$92 million—the \$72.5 million for the building, plus \$5 million for the tenant improvement loan, and \$14.5 million in fees and profit to the seller.²⁵ Additionally, the staff report did not make the connection between the purchase price and the ultimate long-term cost once lease payments are factored in. The total lease payments equal approximately \$128 million. If City Council had been provided these costs in a straightforward manner, it would have better allowed the City Council to weigh its interest in paying \$92 million for a building with an appraised value of only \$67.1 million.

The staff report also did not state that the tenant improvement allowance of \$5 million was a loan that is included in the lease payments over the 20-year period. Furthermore, the tenant improvements assumed new paint and carpet throughout the building and minimal tenant improvements otherwise. At the time the City signed the agreement, the City had not yet started its formal space planning.

Due Diligence

We found that READ relied on the seller to provide all due diligence documents, including the appraisal, broker's opinion of value, environmental condition assessments, and property condition reports. The seller commissioned several of the reports in 2016 during the acquisition period but also provided similar reports of assessments that had been conducted from 1993 to 2014, some of which included the prior building occupant's efforts to remediate asbestos on each floor of 101 Ash. Had READ conducted its own due diligence, it could have used its assessments to drive down the purchase price or consider other alternative properties for purchase.

For 101 Ash's valuation, READ relied on a broker's opinion of value and an appraisal commissioned by the seller to support the already agreed-upon purchase price of \$72.5 million. The City did not use these tools in negotiations with the seller. The appraisal valued 101 Ash at \$67.1 million, \$5.4 million lower than the agreed-upon purchase price. The broker's opinion of value valued 101 Ash at \$83 million to \$85 million. According to an investigative report conducted by Hugo Parker, READ staff used elements of the broker's opinion of value to justify paying higher than the appraised value for 101 Ash. However, brokers' opinions of value are not equivalent to appraisals. Broker's opinions of value are based on the property records a broker has and can be made without any physical inspection of the building or review of due diligence. Additionally, READ's principal appraiser stated that brokers' opinions of value are not as accurate or valid of a measurement of a building's worth compared to appraisals, as the broker provides this service so they can get the property listing.

Hugo Parker reports that the City actually paid \$92 million for 101 Ash, which includes the tenant improvement loan cost of \$5 million and the \$14 million in fees paid to the seller. Ultimately, the City paid 37 percent more than the appraised price of the building—not including interest, operations and maintenance

²⁵ In 2020, the City contracted with Hugo Parker, LLP to review the 101 Ash transaction. The publicly released version of the report can be found here:

https://onbase.sandiego.gov/OnBaseAgendaOnline/Documents/ViewDocument/Att.%201_%20%20Forensic%20Review%20Preliminary%20Report%20on%20101%20Ash%20Street%20_PUBLIC_July%2020202.pdf?meetingId=4099&documentType=Agenda&itemId=191555&publishId=406740&isSection=false

costs, and the actual tenant improvement costs necessary to occupy the building as planned. Had the City used the appraised price only, it could have potentially purchased 101 Ash for a lower price. It also could have considered the value of other buildings in the area and potentially purchased a more expensive building that ultimately needed less remediation and tenant improvements.

Additionally, READ relied on the seller's building condition assessments for 101 Ash. According to an investigative report, the seller's building condition assessments for 101 Ash that were provided to READ expressly stated that the assessments did not include a review of asbestos in the building. Had READ ordered its own assessments, it could have directed the contractors to include a wider scope. Therefore, READ would have been more informed prior to the lease signing about the extent of asbestos in 101 Ash and the other systems needing repairs. With this information, READ could have negotiated for a better price on the building. Furthermore, READ would have had a better idea as to how the extent of the asbestos would affect its planned tenant improvements and associated costs. However, READ did not conduct such a review until after the lease was signed and now 101 Ash is estimated to require \$115 million in unexpected asbestos abatement costs and other costs to update the condition of the building's systems so that the City can use the building as office space for 1,100 employees as originally intended.

READ staff did not conduct a test fit for 101 Ash prior to signing the lease-to-own contract. Although READ staff had initially anticipated to move 1,100 employees into 101 Ash at the time of the lease signing, the plan quickly changed once READ hired a consultant to create a space plan (which also included a test fit).²⁶ The initial plan presented to City Council included renovating only five floors of the building and expected these tenant improvements to cost \$5 million, but this estimate was not based on a test fit or space plan. Once the consultant conducted a test fit, it found the City would need to renovate all 19 floors to maximize space for 1,100 employees. Expanding the scope of the tenant improvements eventually resulted in an estimated project cost of \$26 million, five times the cost initially approved by City Council. Because READ did not perform the asbestos inspection and test fit prior to purchase, the cost of renovations and subsequent asbestos remediation costs are far higher than expected.

City Council Oversight

City staff rushed the 101 Ash lease-to-own acquisition at the end and based it off the very rushed and little-reviewed Civic Center Plaza lease-to-own acquisition. City Management had planned to acquire the building using bond revenues up until September 7, 2016, and had conducted negotiations and building condition research up until that point under the assumption of a deal structured as a purchase using bonds. However, on September 7, 2016, staff decided to restructure the entire acquisition as a lease-to-own agreement and to present that to the Smart Growth and Land Use Committee by September 21, 2016. This gave City staff less than two weeks to conduct any additional research necessary to mitigate the risk to the City presented by the much more complicated structure and to have staff review additional economic analyses on the cost to the City compared to alternative office space. City staff appeared to base much of the 101 Ash lease-to-own transaction on the Civic Center Plaza transaction which, as mentioned above, was a very rushed transaction itself that gave City Council and the IBA very little opportunity to provide oversight. Indeed, the IBA's rushed report on 101 Ash did not include the total \$92 million purchase price even though READ appears to have known the final purchase price. The IBA stated that READ and the City Administration at the time did not inform them of the true price of the building.

²⁶ A test fit is a floor planning exercise to determine if a space will meet a tenant's needs. A space plan is a detailed, in-depth look at the space, including circulation patterns and layouts for furniture and equipment. The difference between a test fit and a space plan is the level of thorough detail.

Although staff did provide the lease-to-own acquisition to City Council committee and did provide information for IBA oversight, staff highlighted to City Council the need to approve the 101 Ash deal the day it was presented or face very high costs. The READ Director at the time even brought up the seller to tell City Council that any changes to the deal or failure to approve the deal could jeopardize the transaction and any savings to the City. The READ Director did not provide City Council with detailed, researched alternatives for office space to consider. This high-stakes ultimatum again left little room for City Council to provide effective oversight and fulfill its legislative role or to ask questions and request additional information, materials, and modifications.

Furthermore, City staff at the time told City Council that 101 Ash was a Class A building. City staff told City Council that the City got a property condition assessment report that showed 101 Ash was in excellent condition and the only immediate need was a \$10,000 exterior power washing and caulking. However, the appraisal for 101 Ash that City staff relied on at the time stated that "even in a rehabilitated condition, the subject property will always be a Class B building." The appraisal and the property condition report the City relied on both state the building is in good condition, not excellent. City staff did not inform City Council that the City relied on the building condition assessment provided by the seller rather than conducting its own, independent, building condition assessment.

READ did not clarify the difficulty in refinancing the 101 Ash lease-to-own terms. The lease-to-own agreement allows the City to purchase the building outright from the seller after five years at a specific rate. The IBA's report at the time of acquisition stated that because of the terms of this provision, it is unlikely this provision would actually be financially beneficial to the City. However, when a councilmember asked if READ would be willing to come back in five years to consider purchasing the building to potentially save the City money, READ said yes and did not mention that refinancing or purchasing the building in line with the terms of the agreement was unlikely.

In August 2020, the City asked a real estate consultant to look into options to refinance the building. The consultant stated it would be next to impossible to refinance the building under the terms of the lease. The cost the City would have to pay the landlord would still be very high. Additionally, the consultant's report notes that the contract requires that the City give irrevocable 90-day notice of refinancing, despite a bond market that may fluctuate within those 90 days and cost the City more than it was planning to pay.

The prior City Administration did not clarify the reasons why it was not proposing to purchase 101 Ash directly. The IBA reported at the time that the City could have saved \$17.2 million had the City been able to purchase 101 Ash from the seller using lease-revenue bonds rather than through a leasing-to-own agreement. The City Administration reported that the City could not purchase 101 Ash using lease-revenue bonds for a number of reasons, including (1) unclear legal language in the purchase and sale agreement between the company selling 101 Ash to the City and the owners of 101 Ash at the time, and (2) not being able to get the bond financing together in time. However, we found issues with these assumptions that were not presented to City Council and these omissions were potentially very costly to the City:

- 1) The City Administration at the time said the City had to acquire 101 Ash through a lease-to-own agreement because the legal language in the purchase and sale agreement between the company selling 101 Ash to the City and the owners of 101 Ash at the time put the City at risk of being sued. The company selling 101 Ash to the City was purchasing 101 Ash from 101 Ash's owners at the time and then immediately selling the building to the City. To arrange this transaction, the company selling to the City had a purchase and sale agreement with the owners of 101 Ash and the company selling to the City told the City they planned to assign that purchase and sale agreement to the City, so the City could effectively buy the building directly using lease-revenue bonds. However, the City Administration reported that the purchase and sale agreement between the company selling to the

City and the owners of 101 Ash at the time was not clear on whether or not the company selling to the City could assign the purchase and sale agreement to the City. Assigning the purchase and sale agreement to the City would mean the City would in effect be buying the property from the owners for the same price the company selling it to the City was buying it for—avoiding the lease-to-own terms and the fees paid to the seller.

This concern about unclear language could have been resolved had the company selling it to the City agreed to clarify the language in the purchase and sale agreement or agreed to seek written consent to assign the agreement to the City. According to READ, the company selling it to the City refused to do either.

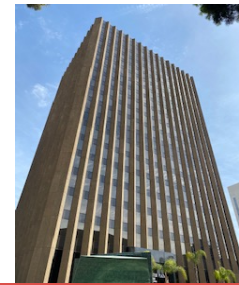
What staff did not make clear to City Council was that the company selling it to the City allegedly had initially agreed to assign the agreement to the City with zero profit to themselves. According to staff, the seller was going to assign the agreement as a “good will gesture towards the City.” Staff said “of course, the Plan B was always a lease-to-own, so they were waiting in the wings to accept a profit should the lease-to-own arrangement become necessary (which it did).”

At the end of the day, the seller's refusal to clarify the language necessitated the lease-to-own arrangement. The seller charged the City \$14.5 million (20 percent) in fees and made a profit on the arrangement.²⁷ City staff dealing with the seller knew the seller had profited from a lease-to-own deal with the City before—the City paid the same seller a 10 percent profit when the City leased-to-own the Civic Center Plaza building from the seller. City staff should have been skeptical of the seller when they allegedly were planning to forgo profit to do the City a favor. The City Administration should have made it clear to City Council that the City would be paying more for the building in a 20-year arrangement because the seller refused to clarify the language and, in refusing to clarify the language, put themselves in a position to make a profit.

- 2) City staff represented that bonds would not have worked with the unclear purchase and sale agreement language and timing concerns, but that does not appear to be accurate. As mentioned above, the IBA reported at the time that the City would save \$17.2 million if it could buy 101 Ash with bonds rather than through the lease-to-own arrangement. In City Council meetings, when asked by multiple councilmembers why the City could not save the estimated \$17.2 million and buy 101 Ash directly, City staff cited the unclear language in the purchase and sale agreement. However, the Deputy Chief Operating Officer overseeing READ at the time also stated they would not be able to raise bond financing to meet the seller's deadline, and if the City did issue the bonds without clear language, there was a risk the City would be sitting on a bond issuance without a building if the owner sued the City and the seller over the unclear purchase and sale agreement language. However, according to the Chief Finance Officer at the time and the Debt Management Department Director, the City could have purchased 101 Ash with bonds within the time constraints. City staff were so confident the City could have purchased 101 Ash with bonds that staff had docketed a staff report to go to City Council for approval of the bond issuance. Additionally, the Debt Management Department Director stated that being left without a building was not a risk, as staff had included a contingency in the ordinance for the City to use the bonds funds for alternative City infrastructure needs if the 101 Ash acquisition did not close. However, the City Administration decided not to finance the building with bonds and only presented City Council with the lease-to-own option instead.

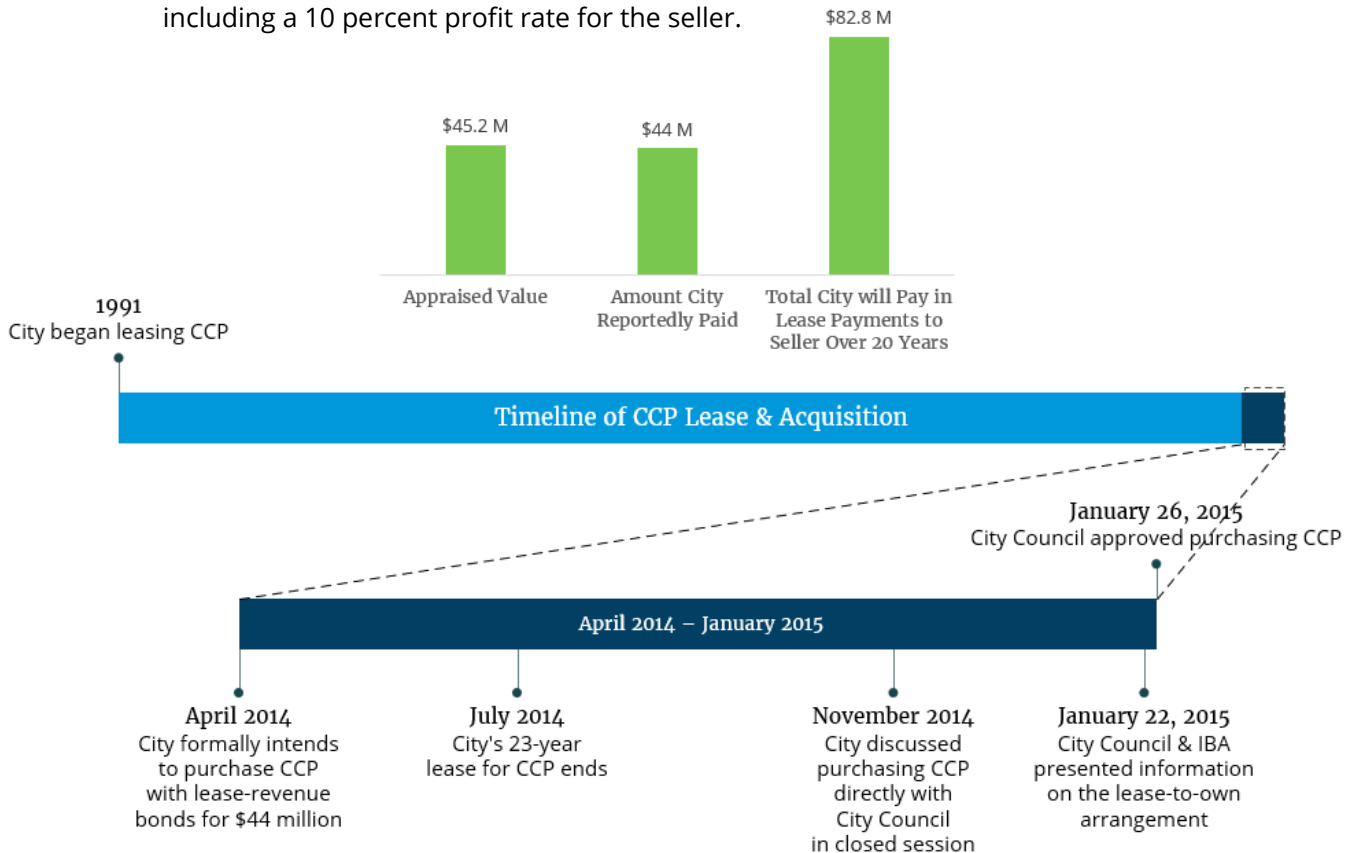
²⁷ \$14.5 million is 20 percent of the building's reported cost of \$72.5 million.

Appendix B: What Happened on the Civic Center Plaza Acquisition?



Key Issues

- Real Estate Assets Department (READ) staff provided City Council and the Independent Budget Analyst's Office only four days to review the lease-to-own agreement. READ staff reported that the City Council had to approve the purchase that day or face significantly increased costs and lose out on cost savings.
- Although the City knew when it entered into the lease for Civic Center Plaza in 1991 that it would end in 2014, the City rushed to acquire the building after the lease ended and did not present any alternative plans for office space.
- The City used an uncontracted real estate advisor to consult on the acquisition, without gathering any disclosures on the advisor's economic interests or ensuring the advisor had a contract to act in the City's best interest. The advisor was paid \$5 million by the building's seller.
- The staff report did not disclose the costs built into the lease-to-own agreement, including a 10 percent profit rate for the seller.



Strategic Plan

The Civic Center Plaza and King Chavez High School Facility (CCP) property was not in the City's Portfolio Management Plan, as READ did not update the plan from fiscal year 2010 to 2016, and the plan did not specifically articulate a plan for the need for downtown office space and plan for office space in the future.²⁸ Although the City knew when it entered into the lease for CCP in 1991 that it would end in 2014, the City rushed to acquire the building after the lease ended and did not have alternative plans for office space.

Business Case

READ presented the need to purchase CCP as reducing the City's office space costs once the City's lease ended at CCP.

Roles & Responsibilities

Roles and responsibilities in the City for acquiring buildings are overall unclear.

The City used an unpaid real estate advisor to consult on the acquisition, without gathering any disclosures on the advisor's economic interests or ensuring the advisor had a contract to act in the City's best interest. According to the City Attorney's Office, the advisor then was paid \$5 million by the building's seller.

Economic Analysis

The staff report to City Council did not include alternatives to purchasing CCP through a lease-to-own deal except simply continuing to lease CCP. READ did not present and compare alternative space to lease or purchase, or alternative methods to fund the CCP acquisition.

The staff report did not disclose the costs built into the lease-to-own agreement, including a 10 percent profit rate for the seller and \$5 million paid through the seller to the City's uncontracted advisor. The seller for CCP was the same as the seller for 101 Ash.

READ staff reported the necessary improvement costs for CCP, detailing the results of an independent building condition assessment. READ also proposed funding those costs through the City's Capital Improvement Projects rather than funding them through the seller at a higher interest rate (which was done on 101 Ash).

Due Diligence

The City contracted for an independent appraisal of CCP before signing the lease-to-own agreement and disclosed the appraised value to City Council. The building was appraised for \$45.2 million. The City will make a total of \$82.8 million in lease payments over 20 years.

The City contracted for an independent building condition assessment in addition to the one provided by the seller. City staff reported the assessments found CCP would need \$6.4 million in improvements over the first five years of the lease-to-own agreement. We do not have evidence that the City conducted a test fit. However, the City had occupied the building for more than 20 years and therefore was familiar with its condition and configuration. Reviews of the City's office space in the last ten years have found that CCP's office space is underutilized due to the space not being easily configurable.

City Council Oversight

²⁸ The Civic Center Plaza building, and King Chavez High School facility are on one plot of land. In this report we discuss them together as Civic Center Plaza.

City staff did not present the lease-to-own arrangement to the Smart Growth and Land Use Committee, which oversees the City's real estate.

City staff originally presented the acquisition to City Council in closed session, but as a direct purchase using lease-revenue bonds and not as a lease-to-own agreement.

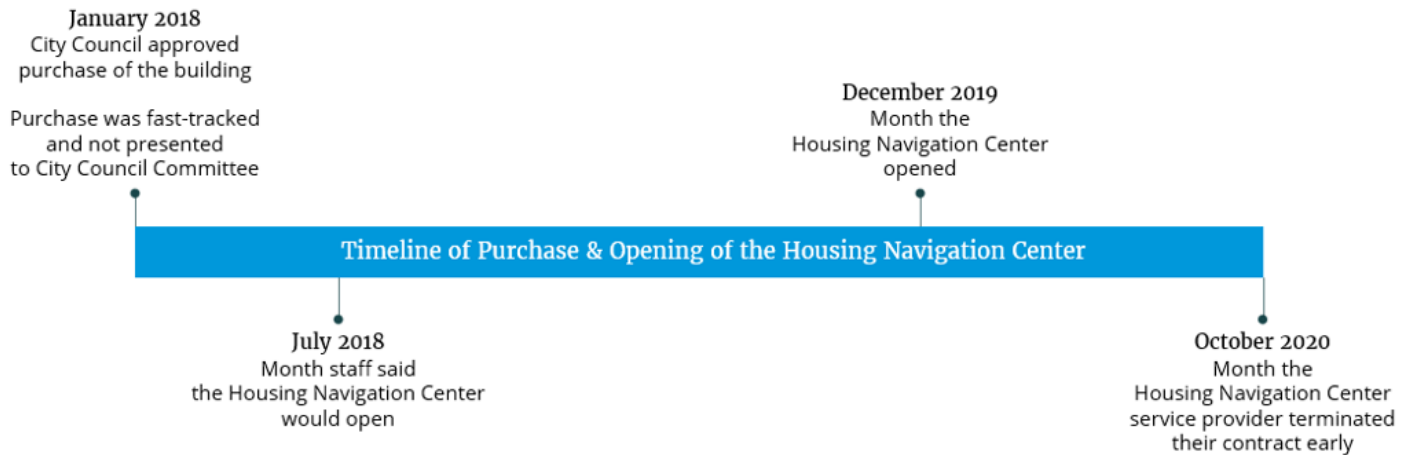
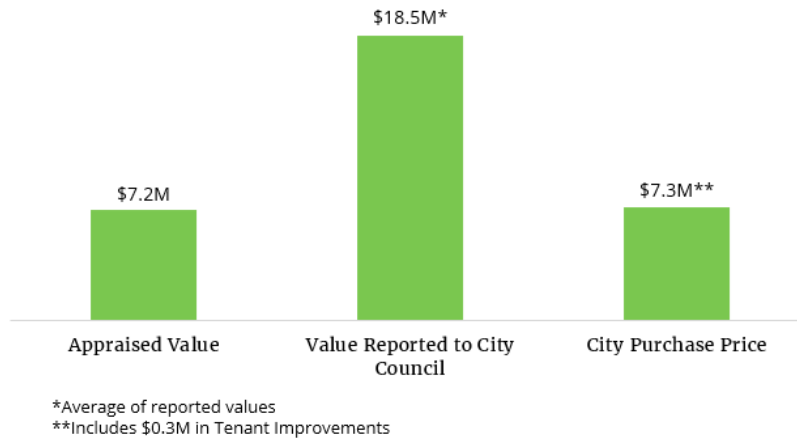
City staff provided City Council and the Independent Budget Analyst's Office only four calendar days to review the lease-to-own agreement. City staff reported that the City Council had to approve the purchase that day or face significantly increased costs and lose out on cost savings.

Appendix C: What Happened on the Housing Navigation Center Acquisition?



Key Issues

- The City did not obtain an independent appraisal before purchasing the building. Instead, it relied on the seller's appraisal that valued the building based on its potential income as a skydiving center, when the City planned to use the building as a facility to serve people experiencing homelessness.
- City staff told City Council that the City was acquiring the building for well below the market rate of \$15 million to \$20 million. However, when the City did conduct an appraisal after purchasing the building, the value essentially aligned with what the City paid—\$7 million—meaning that the building was not the great deal that the prior City Administration portrayed to City Council and the public.



Strategic Plan

The Portfolio Management Plan did not include the need for the Housing Navigation Center.

Business Case

The City's original request for proposal for a housing navigation center included space for an emergency shelter for people experiencing homelessness, in line with the City and County of San Francisco's model. The indoor skydiving facility did not accommodate plans for a shelter. The City issued a new request for proposal for services for the Housing Navigation Center without the shelter only after requesting City Council approve the purchase of the building. At the time of purchase, the City did not have an established set of services in place for the center or a vendor to run it. The Independent Budget Analyst report on the approval of services noted that the Housing Navigation Center did not clearly fit into the context of the City's homelessness services and regional planning framework.²⁹

Roles & Responsibilities

The acquisition did not have a lead acquiring department within the City Administration. The Real Estate Assets Department (READ) understood the Economic Development Department to be leading the acquisition, while Economic Development said the Mayor's Office was leading the acquisition.

Economic Analysis

The staff report to City Council did not include any comparisons to alternative properties or service models for consideration.

Due Diligence

The City did not conduct an independent appraisal before purchasing the facility. The City relied on an appraisal provided by the seller that valued the property at \$22 million, based on the income it would generate as an indoor skydiving facility. The City used funds from the U.S Department of Housing and Urban Development (HUD), which post acquisition, requested the City contract for an independent appraisal of the property in response to a complaint made to HUD. The independent appraisal found the facility's appraised value to be \$7.2 million—in line with the \$7.3 million the City paid for the building and tenant improvements, but not near the value City Administration presented.

The City did not conduct any other building condition assessments or test fits prior to purchasing the building. After purchasing the building, an Americans with Disabilities Act compliance assessment highlighted changes necessary.

City Council Oversight

READ staff did not present the building to a City Council Committee for oversight.

The Independent Budget Analyst did not produce a report on the building acquisition.

READ staff presented a compressed timeline for City Council consideration—the City Council had to agree that day or risk losing the cost savings on the building.

READ staff misrepresented the value of the building to City Council and the public. Staff relied on an appraisal that valued the property at \$22 million, based on the income it would generate as an indoor skydiving facility. Staff also relied on a broker's opinion of value presented by the seller that stated the property was worth about \$15 million. However, READ staff have stated since that brokers' opinions of value are often inflated. Staff did not disclose that the City had not conducted its own appraisal.

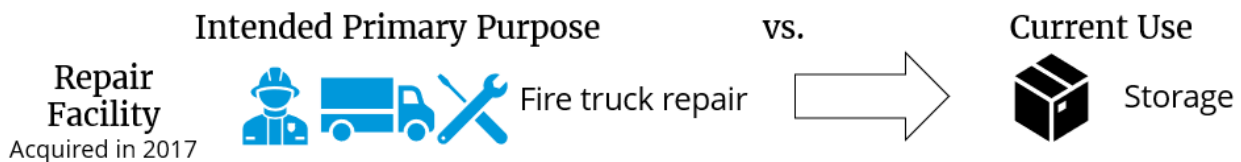
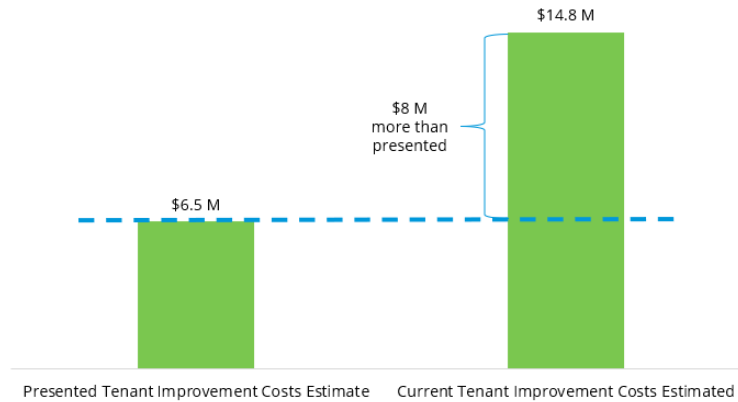
²⁹ https://www.sandiego.gov/sites/default/files/20-009_homelessness_0.pdf

Appendix D: What Happened on the Kearny Mesa Repair Facility Acquisition?



Key Issues

- City staff based estimated tenant improvement costs on an unrelated structure, not on a test fit based on the layout of the Kearny Mesa Repair facility.
- The City now estimates tenant improvements will cost \$14.8 million, more than twice the \$6.5 million cost staff presented to City Council when proposing to lease the building.
- The City will be 5 years into a 15- to 30-year lease before it could potentially use the facility to repair fire trucks, which was the main need for the facility.



Strategic Plan

The City entered into a 15-year lease agreement for the Othello Avenue property to use as a repair facility for fire trucks.³⁰ The Real Estate Assets Department (READ) had not identified the need for the property in its Portfolio Management Plan.

Business Case

The Fleet Operations Department did establish a business case for leasing the property. The City currently uses the Miramar Repair Facility to repair both fire trucks and trash trucks. A consultant report in 2014 found that the Miramar facility did not have the space necessary to efficiently repair both types of trucks, resulting in repairs taking more time. Because the repairs took more time, the City had to purchase additional trucks to cover for the trucks out of commission awaiting repair. Leasing more space to repair trucks would decrease costs to the City.

The City pursued the long-term lease of the Kearny Mesa Repair Facility primarily to repair fire trucks, but also noted it could act as a storage facility. Because of the versatility identified in the property, staff did not conduct a detailed test fit and associated tenant improvement cost estimate to ensure that the Kearny Mesa Repair Facility was suitable to accommodate fire truck repair. It was only after the lease was signed that the City contracted for a full-scale design of the property that estimated the total renovation would cost \$14.8 million, far above the original estimate of \$6.5 million. As a result, City officials have spent more than three years trying to scale back the costs and the facility currently sits unused for its primary purpose while inefficiencies persist at the Miramar Repair Facility.

Roles & Responsibilities

The Fleet Operations Department was the acquiring department for the facility. However, Fleet Operations Department staff said READ was responsible for conducting due diligence on the building, including ensuring the City understood the condition of the building; whereas READ said all building condition assessments to understand the condition of the building were the Fleet Operation Department's responsibility.

Economic Analysis

The base rent cost for the facility totals \$14.1 million over the 15-year lease. The economic analysis staff reported to City Council included an estimated \$6.5 million in tenant improvement costs. However, the City now estimates the leased property will need \$14.8 million in tenant improvements to use it as a repair facility—\$8 million more than initially reported.

The economic analysis did not include a comparison to alternative properties, and it is unclear if the City searched for other properties taking into account both the lease price and the tenant improvement costs required.

Due Diligence

The City did not obtain an appraisal on the facility to establish that the lease rate was in line with the market. Additionally, the City did not appraise the property despite the anticipated \$6.5 million in tenant

³⁰ The City originally entered into a 10-year lease with two 5-year extension options. The City amended the lease to expand it to a 15-year lease with three 5-year extension options. The agreement is a lease, not a lease-to-own agreement, so the City will not own the property at the end of the lease but has the first right of refusal to purchase the property at the end of the lease.

improvements that the City planned to invest. Now that the tenant improvement cost has increased, the City is poised to make a significant real estate investment in a property that it may never own.

The City did not conduct any building condition assessments on the facility. READ did not inform the Environmental Service Department's Asbestos and Lead Management Program of the lease agreement and no asbestos or hazardous material inspection was conducted prior to the signing the lease.

The City did not perform a full test fit for the Kearny Mesa Repair Facility prior to signing the lease. As mentioned above, this has resulted in tenant improvement cost estimates increasing significantly.

City Council Oversight

The initial 10-year lease of the facility passed on the consent agenda for both the City Council Smart Growth and Land Use Committee and the City Council as a whole. The staff report did not include any high-stakes timelines and appear to have provided sufficient time for oversight.

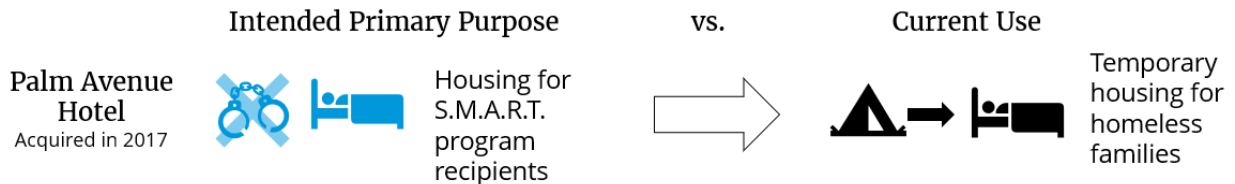
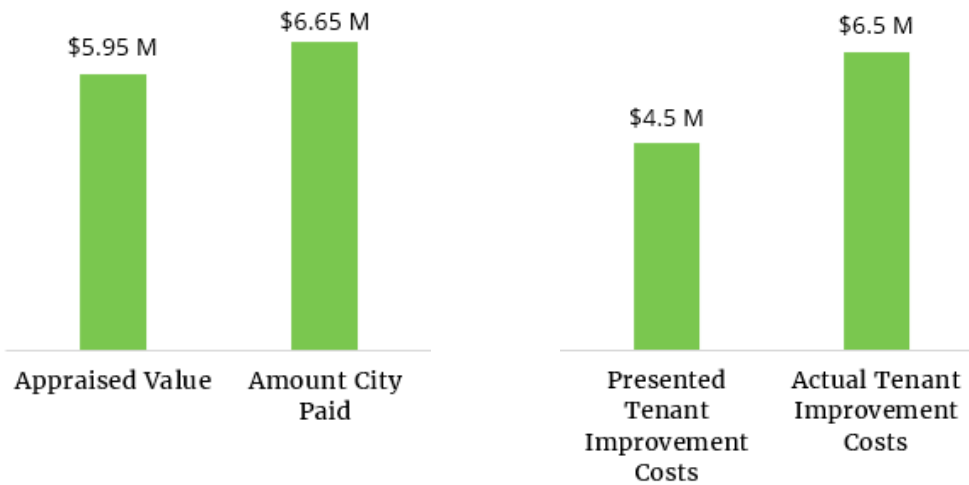
However, after anticipated tenant improvement costs increased substantially, the Fleet Operations Department and READ were required to return to City Council to amend the lease agreement because of the problems that had arisen. The departments proposed extended the lease agreement from 10 years with two 5-year extension options to 15 years with three 5-year extension options. City Council routed this proposal and update through the Active Transportation and Infrastructure Committee, rather than the Smart Growth and Land Use Committee, which oversaw the original lease and oversees the City's land use.

Appendix E: What Happened on the Palm Avenue Hotel Acquisition?



Key Issues

- No major areas of concern.



Strategic Plan

The Portfolio Management Plan did not identify the need for the hotel.

Business Case

The purpose of acquiring the Super 8 Hotel on Palm Avenue was to provide transitional housing for participants in the San Diego Misdemeanants At-Risk Track (S.M.A.R.T.) Program, who were often people experiencing homelessness.

Roles & Responsibilities

The acquiring department leading the acquisition was unclear. Real Estate Assets Department (READ) staff reported that the Economic Development Department was the lead acquiring department. The Economic Development Department indicated that it provided the funding. The City Attorney's Office said it was the lead department for the S.M.A.R.T. Program and the Economic Development Department provided the funding, but the lead acquiring department for the building itself was the Mayor's Office.

Economic Analysis

The economic analysis presented to City Council included tenant improvements costs of \$4.5 million, but tenant improvements totaled \$6.5 million. The economic analysis did not include comparisons to any other properties or alternative solutions. The economic analysis did not explain the benefits or costs of using Community Development Block Grant funds over other sources of funding.

Due Diligence

The City contracted for an independent appraisal. The appraisal valued the property at \$5.95 million. The City paid \$6.65 million (about 12 percent more).

The City did not conduct any building condition assessments prior to acquiring the building.

City Council Oversight

READ staff did not present the building acquisition proposal to the Smart Growth and Land Use Committee, which is the committee that oversees the City's real estate. Staff presented the S.M.A.R.T. Program and the hotel acquisition to the Public Safety and Livable Neighborhoods Committee instead.

The Independent Budget Analyst did not prepare a report for City Council on this item.

Appendix F: Definition of Audit Recommendation Priorities

The Office of the City Auditor maintains a priority classification scheme for audit recommendations based on the importance of each recommendation to the City, as described in the table below. While the City Auditor is responsible for providing a priority classification for recommendations, it is the City Administration's responsibility to establish a target date to implement each recommendation, taking into consideration its priority. The City Auditor requests that target dates be included in the Administration's official response to the audit findings and recommendations.

Priority Class ³¹	Description
1	<p>Fraud or serious violations are being committed.</p> <p>Significant fiscal and/or equivalent non-fiscal losses are occurring.</p> <p>Costly and/or detrimental operational inefficiencies are taking place.</p> <p>A significant internal control weakness has been identified.</p>
2	<p>The potential for incurring significant fiscal and/or equivalent non-fiscal losses exists.</p> <p>The potential for costly and/or detrimental operational inefficiencies exists.</p> <p>The potential for strengthening or improving internal controls exists.</p>
3	<p>Operation or administrative process will be improved.</p>

³¹ The City Auditor is responsible for assigning audit recommendation priority class numbers. A recommendation that clearly fits the description for more than one priority class shall be assigned the higher priority.

Appendix G: Audit Objectives, Scope, and Methodology

Audit Objectives

In accordance with the Office of the City Auditor's Fiscal Year (FY) 2021 Audit Work Plan, we conducted a performance audit of the City of San Diego's Major Building Acquisition Process. Our objectives were to:

1. To determine if the City followed policies and best practices when purchasing buildings or entering into lease agreements worth more than \$5 million from FY2015 to FY2019; and
2. To determine if the City has sufficient governance mechanisms for oversight of purchases and lease agreements worth more than \$5 million from FY2015 to FY2019.

Scope

Real estate terminology tends to define real estate asset acquisitions as direct purchases. However, because our scope includes review of buildings the City obtained via direct purchase, lease, and lease-to-own, we use the term *acquisition* to refer to all three methods.

Our review focuses on the acquisition process at the City for the select buildings in our scope up until the point of acquisition but does not include a review of the aftermath of these acquisitions. Therefore, our analysis does not include decisions on tenant improvements, contractors selected for renovations, and asbestos abatements. However, as discussed in the report, shortcomings in the acquisition process can increase the risks and costs associated with buildings after they are purchased. The buildings in our scope include 101 Ash Street, the Civic Center Plaza and King Chavez High School buildings, the Housing Navigation Center, the Kearny Mesa Repair Facility, and the Palm Avenue Hotel.

Internal Controls Statement

We determined that several internal control principles outlined in the United States Government Accountability Office's Standards for Internal Control in the Federal

Government are significant to our audit objectives above. Specifically, as part of our audit we reviewed the City's adherence to the following internal control principles:

- The oversight body and management should demonstrate a commitment to integrity and ethical values.
- The oversight body should oversee the entity's internal control system.
- Management should establish an organizational structure, assign responsibility, and delegate authority to achieve the entity's objectives.
- Management should demonstrate a commitment to recruit, develop, and retain competent individuals.
- Management should evaluate performance and hold individuals accountable for their internal control responsibilities.
- Management should define objectives clearly to enable the identification of risks and define risk tolerances.
- Management should identify, analyze, and respond to risks related to achieving the defined objectives.
- Management should consider the potential for fraud when identifying, analyzing, and responding to risks.
- Management should identify, analyze, and respond to significant changes that could impact the internal control system.
- Management should design control activities to achieve objectives and respond to risks.
- Management should implement control activities through policies.
- Management should use quality information to achieve the entity's objectives.
- Management should internally communicate the necessary quality information to achieve the entity's objectives.

- Management should externally communicate the necessary quality information to achieve the entity's objectives.
- Management should establish and operate monitoring activities to monitor the internal control system and evaluate the results.
- Management should remediate identified internal control deficiencies on a timely basis.

Audit Objective Methodology

Determine if the City followed policies and best practices when purchasing buildings or entering into lease agreements worth more than \$5 million from FY2015 to FY2019

- Reviewed the City Charter, City Council policies, municipal code, and department policies and guidelines related to building acquisitions and City roles and responsibilities.
- Benchmarked the City's building acquisition process against the City of Austin, City of Phoenix, City of San Jose, City of Seattle, County of Los Angeles, County of San Diego, San Diego Association of Governments, and State of California.
- Compared real estate best practices of local, state, federal, and commercial building acquisition processes to the City's process.
- Reviewed previous City audits and contractor reviews of the Real Estate Assets Department (READ).
- Reviewed READ's portfolio management plans and an assessment of the City's office space use.
- Toured the Housing Navigation Center, Palm Avenue Hotel, Miramar Repair Facility, and Kearny Mesa Repair Facility.
- Reviewed each building's lease agreements, purchase and sale agreements, appraisals, brokers opinions of value, building condition assessments, Phase I and II environmental reviews, test fits, and other documents as applicable.
- Reviewed costs in SAP of buildings acquired, lease payments, and tenant improvement costs to date.

Determine if the City has sufficient governance mechanisms for oversight of purchases and lease agreements worth more than \$5 million from FY2015 to FY2019

- Reviewed the City's asbestos policies and procedures as they apply to building acquisitions.
- Interviewed staff in the Real Estate Assets Department, Economic Development Department, Department of Finance, Debt Management Department, Environmental Services Department's Asbestos and Lead Management Program, General Services Department Fleet Operations Division, Development Services Department, Homeless Strategies Division, City Attorney's Office, and Independent Budget Analyst's Office. In total, we conducted more than 40 interviews for this report.
- Interviewed former City officials, including the former Mayor's Chief of Staff and Deputy Chief of Staff/Chief of Policy, two former Chief Operating Officers, the former Assistant Chief Operating Officer, the former Chief Financial Officer, two former Asbestos Program Managers, a former Civic San Diego Vice President of Planning, and a former program manager with the Economic Development Department. (We also requested interviews with the former Mayor, READ Director, Deputy Chief Operating Officer overseeing READ at the time, and the uncontracted advisor – all of whom did not agree to timely interviews for this report).³²
- Reviewed correspondence of officials involved in the 101 Ash, Civic Center Plaza, and Housing Navigation Center transactions.
- Reviewed the state and the City's economic disclosure and conflict of interest policies and procedures.

³² San Diego City Charter Section 39.2 provides the Office of the City Auditor the authority to summon "any officer, agent, or employee of the City, any claimant or other person," necessary for investigation of any material claim of financial fraud, waste, or impropriety within any City department. However, the City currently lacks any penalties for failure to comply with this section of the City Charter, which limited our ability to compel the cooperation of former employees or agents of the City. We plan to propose an amendment to the municipal code to address this in the near future.

- Reviewed footage of the City Council and City Council Committee presentations on the proposed acquisitions and subsequent Council updates.
- Reviewed staff reports to City Council and compared them to information City staff had at the time, including email correspondence and supporting documents.
- Reviewed Independent Budget Analyst reports to City Council.

Compliance Statement

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Performance Audit of the City's Major Building Acquisition Process

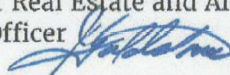


THE CITY OF SAN DIEGO

M E M O R A N D U M

DATE: July 22, 2021

TO: Andy Hanau, City Auditor

FROM: Penny Maus, ^{fix} Director, Department of Real Estate and Airport Management
via Jay Goldstone, Chief Operating Officer 

SUBJECT: Management's Response to the Performance Audit of the City's Major Building Acquisition Process

This memorandum provides background information and management's response regarding the Audit of the City's Major Building Acquisition Process. We would like to thank the Office of the City Auditor for their thorough review of five acquisitions that occurred under the prior Administration and with prior Management of the Department of Real Estate and Airport Management (Department) formerly known as Real Estate Assets Department (READ).

Overall, we agree that the City should formalize its acquisition process through a comprehensive update of its current leasing policy, Council Policy 700-10, (Policy) and the real estate Portfolio Management Plan (PMP) as these are documents that have not been updated in many years. Both the Policy and PMP can not only be revised to be current, they can be more transparent for the benefit of the City Council and the Public.

We agree with City Auditor's conclusions that the City's major building acquisition process should be improved to clarify roles and responsibilities, establish clearer processes, and provide greater disclosure and transparency over these types of transactions. However, we respectfully do not agree with the prescriptive nature of many of the Audit's recommendations, which we have communicated to the City Auditor's team during the course of this audit. Administrative Regulation 15.10 *Audit Report Replies Required of Departments* requires that Management either agree or disagree with all elements of recommendations set forth in the report. As a result, even though we broadly agree with many of the recommendations in concept, we are necessarily required to disagree to those recommendations where we have an area of disagreement with even a single element of a recommendation with multiple sub-elements. We have noted those areas throughout our responses below. Additionally, there are also some recommendations that require responses from other departments and we have noted those accordingly.

We look forward to working with the City Auditor on implementing the recommendations, in whole or in part, and putting the City in a better position as we approach future real estate transactions including, but not limited to, acquisitions.

Recommendation #1: As the lead department, we recommend the Real Estate Assets Department (READ), in consultation with the Independent Budget Analyst (IBA), City Attorney's Office, and other departments as needed, create a new or amended Council Policy for City Council's approval that requires a best practices checklist for building acquisitions. READ and other departments as detailed in the new or amended policy would complete and present the checklist to City Council for every building purchase or lease agreement that requires City Council approval. The checklist in the Council Policy should establish the following steps to be taken and presented to City Council:

- a. Determination of how a building acquisition fits in the strategic plan detailed in Recommendation 3.
- b. Determination of what the building will be used for and to what extent the building fits the business case.
- c. Completion of a funding method analysis, with input from the Debt Management Department.
- d. Determination of estimated tenant improvement costs supported by relevant data. Tenant improvement proposals should be presented and approved with the building acquisition. Tenant improvements proposals should include detail on how the tenant improvements will ensure the building meets the City's needs and detail on the anticipated cost and timeline.
- e. Completion of an overall economic analysis including consideration of other acquisition options, with input from the Chief Financial Officer.
- f. Completion and presentation of a due diligence checklist (see details in Finding 2, Recommendation 5), including a high-level summary of the due diligence materials obtained by READ and their findings. The due diligence materials obtained by READ and provided at least in summary to City Council should include but not be limited to appraisals, building condition and environmental assessments, and the assessments' findings. Findings from assessments may include the building's Americans with Disabilities Act compliance, the presence of hazardous materials, the results of a building systems investigation, and the results of an asbestos inspection.
- g. Identification and designation of a set City Council committee to oversee building leases or purchases that require City Council approval.
- h. Presentation of the City Attorney's Office's written analysis of the significant legal risks of the contract.
- i. Review of completion of items on the checklist by the IBA or the IBA's as-needed consultant to the best of their knowledge. This review may include an analysis of how well the best practices have been conducted.
- j. City staff may note in the checklist if steps required in the checklist were not completed and why. City staff should provide material to the IBA to support each component of the checklist, including the rationale to not complete checklist steps. (Priority 1)

Management Response: Agree/Disagree

Agree: While we agree with the recommendation to update the current Policy, we have concerns with the prescriptiveness and length of this recommendation. We agree that the Policy should be updated to reflect the process for an acquisition, but the Policy should also include other primary functions of the Department, including: dispositions, lease administration, municipal asset services and valuation. It is envisioned that the Real Estate

Management Team will thoroughly review the Policy and PMP, benchmark it against other agencies and the private sector to become a comprehensive real estate policy. It would be

Page 3

Andy Hanau, City Auditor

July 22, 2021

optimal to fold other Council policies in, either in whole or in reference, such as leasing to non-profits and in Balboa Park.

Recommendation g is unnecessary as there is a Committee that currently provides this oversight, Land Use and Housing (LU&H). Real Estate staff is ultimately not in control of docketing, but we do concur that staff should make its best efforts to docket items for presentation at LU&H, prior to presenting to the full Council.

Disagree: We disagree with a boilerplate checklist that prescribes the due diligence that should be conducted as part of an acquisition, as no two real estate transactions are alike. Rather than having staff explain why they may not have conducted some components of traditional due diligence, we believe it would be more productive for staff to instead identify what due diligence was conducted and why. We also envision that our staff reports will be more transparent moving forward and due diligence that is completed as part of a transaction, will either be attached or be referenced so a Council Member or member of the public could request the document to review it (such as a Phase 1 Environmental Report).

Not Applicable to the Department: There are also several components of this recommendation (h and i) that would be the responsibility of other departments so our response is not an agree or disagree from those departments, we will defer to their responses.

Target Date: July 1, 2022

Recommendation #2: When drafting the Council Policy set out in Recommendation 1, we recommend that the Real Estate Assets Department (READ), in consultation with the Independent Budget Analyst (IBA), City Attorney's Office, and other departments as needed, create an Administrative Regulation to establish clear roles and responsibilities for City departments involved in the acquisition process or with expertise to contribute to the acquisition process. The Administrative Regulation that correlates to the Council Policy in Recommendation 1 should, at minimum, include roles and responsibilities for the departments listed below.

- a. **Acquisition lead.** The policy should set out the role and responsibilities of the acquisition decisionmaker, as well as the acquiring department, if the parties are different. READ can require the acquisition decisionmaker to provide information to READ for the checklist, such as the business case for the building and the desired funding method.
- b. **READ.** READ's role in transactions should be clearly defined, including its responsibility in taking the lead on negotiations and conducting due diligence. READ should conduct an economic analysis of purchasing the building in question compared to other options, as well as an economic analysis of using the funding method recommended compared to other funding methods. READ should consult with the Department of Finance and the Debt Management Department for the economic analysis. READ should be the party responsible for completing the due diligence checklist and ensuring the information presented is accurate.
- c. **City Attorney's Office.** The City Attorney's Office should prepare and present a written legal analysis of the significant risks in each building's acquisition contract for all buildings that require City Council approval. The written legal analysis may be included as a dedicated section within the staff report to City Council or may take the form of a separate memo.

- d. **Independent Budget Analyst (IBA).** The IBA should be notified and provided all relevant information on building purchase acquisitions at the time a building has been identified and prior to the start of negotiations. The IBA would not be involved in the operations and management side of acquiring the building, but should be provided information to conduct a sufficient and timely analysis of the best practices followed or not followed. The IBA should also review the best practices checklist (as described in Recommendation 1) and hire a consultant for review of the checklist as needed. (Priority 1)

Management Response: Agree/Disagree

Agree: We agree with the recommendation that the policy shall clearly identify roles and responsibilities.

Disagree: We do not agree to notify and provide information to the IBA prior to the start of negotiations as stated in recommendation d. We will work collaboratively with the City Council and the IBA and provide timely briefings and information as appropriate.

Not Applicable to Department: City Attorney's Office or IBA will need to respond to the recommendation with regards to recommendations c and d.

Target Date: July 1, 2022

Recommendation #3: We recommend that the Real Estate Assets Department (READ), in consultation with the City Administration, develop and use a strategic real estate and office space plan. The plan should include the current space usage and a plan for future office space usage for City properties. The Council Policy described in Finding 1 should require READ to present the plan to the designated City Council committee and the City Council for input, changes, and approval every two years. (Priority 2)

Management Response: Agree

We agree with the recommendation to develop and use a comprehensive strategy regarding space needs. Given the size of the City with its 11,000+ employees and over 1,600 facilities, implementation of this recommendation will require extensive work and the Department will need to retain a third-party consultant to assist with initial data gathering. Additional staff will also be needed to assist the Municipal Asset Services team to effectively develop, implement and manage such a plan, including a person with expertise in space needs planning.

Target Date: February 1, 2023

Recommendation #4: We recommend that the Council Policy set out in Recommendation 1 also require all contractors or advisors with significant input on real estate transactions to have a signed contract with the City and a determination form filed with the Office of the City Clerk by the contracting department. Additionally, we recommend that the policy in Recommendation 1 require the best practices checklist presented to City Council for real estate acquisitions to include a section disclosing any consultants or advisors to the City that were involved in the acquisition. Before presenting the checklist to City Council, the lead department on the acquisition should confirm with the Office of the City Clerk that each consultant or advisor listed has a Consultant Determination Form on file, and that any

consultants and advisors have filed a Statement of Economic Interests form if necessary.
(Priority 1)

Management Response: Agree/Disagree

Agree: We agree that contractors or advisors should have a signed contract with the City, as required by the City Charter and Municipal Code. Further, the Political Reform Act (Gov. Code sections 81000-91014) which requires disclosure of personal assets as well as self-disqualification from participating in decisions which may affect their personal economic interests as well as the City's Conflict of Interest Code for the Office of Mayor and the Department are to be followed. The specific guidelines mentioned in the recommendation are the steps required under these existing

Disagree: We disagree that the lead department shall be responsible for ensuring that client departments have appropriately followed this policy. The disagreement arises out of several concerns with the recommendation: 1) The term "significant" is vague and should be clearly defined for thorough and clear implementation, 2) It is redundant to require that one department verifies the work of another, 3) "Consultants and advisors" are utilized in many capacities, for space planning, IT consulting, environmental, appraisers, design and construction management, mechanical and system diagnosis and or recommendations etc. They can be a primary vendor or a sub of a prime. To implement, the recommendation should be more specific as to what types of "consultants or advisors" would fall under this recommendation.

Target Date: July 1, 2022

Recommendation #5: We recommend that the Real Estate Assets Department (READ) create a due diligence checklist in an Administrative Regulation to ensure that the due diligence items (as recommended in Recommendation 1f) are accounted for prior to purchase and presentation to a designated oversight committee. READ should be responsible for completing this checklist, and if READ determines an item is unnecessary for a particular acquisition, READ should be responsible for reporting with supporting information why READ chose not to complete the required item. The checklist should include, but is not limited to, the following items:

- a. **Independent Appraisals.** READ should contract for an appraisal for the building early in the negotiations on purchase price, before the purchase price is agreed upon.
- b. **Independent Building Condition Assessments.** READ should create a policy on what assessments (e.g., facilities, systems, hazardous materials, ADA, plumbing, geotechnical, etc.) are required and when and who is responsible for ensuring they are conducted.
- c. **Environmental Assessment.** READ should hire a contractor and/or have qualified City staff perform a Phase 1 environmental assessment.
- d. **Independent Asbestos Assessment.** READ should engage the Asbestos and Lead Management Program to determine if an asbestos inspection is necessary before entering into a purchase and sale agreement. Asbestos inspection conclusions should be considered in the building's negotiated purchase price and/or for future tenant improvements.
- e. **Test fit.** READ should create a policy on when a test fit is required and when and who is responsible for ensuring it is completed and included in the tenant improvement cost and cost/benefit analysis. (Priority 1)

Management Response: Disagree

While we agree that an appraisal shall be completed prior to a purchase price being agreed upon, it may be at different points in time based upon the transaction itself and the level of due diligence that is required. Therefore, we will agree to have appraisals completed prior to presenting a recommendation to Committee and/or City Council on a transaction. As previously noted, we disagree with a checklist that prescribes the due diligence that should be conducted as part of an acquisition, as no two real estate transactions are alike. Rather than having staff explain why they may not have conducted some components of traditional due diligence, we believe it would be more productive for staff to instead identify what due diligence was conducted and why. We also envision that our staff reports will be more transparent moving forward and due diligence that is completed as part of a transaction, will either be attached or be referenced so a Council Member or member of the public could request the document to review it (such as a Phase 1 Environmental Report). However, the revised Policy could note that examples of “due diligence” may include, but are not limited to items a-e.

Target Date: July 1, 2022

Recommendation #6: We recommend that the Council Policy set out in Recommendation 1 also require that the Real Estate Assets Department (READ) or the acquisition lead present the best practices checklist to City Council and demonstrate that all pertinent departments have signed off on all aspects of the acquisition process. The due diligence supporting materials, including those listed in Recommendation 4, must also be made available to City Council members and the public. (Priority 1)

Management Response: Agree/Disagree

Agree: We agree to include or reference in our staff reports going forward, all due diligence reports and files conducted and available.

Disagree: Again, we disagree with the notion of a prescriptive checklist as stated in the response to recommendations #1 and #5.

Target Date: Immediately

Recommendation #7: We recommend that the Independent Budget Analyst, in consultation with the City Attorney’s Office, create and bring forward to City Council for approval a section to be added to the San Diego Municipal Code to provide an enforcement mechanism for Charter Section 32.1, to ensure that City staff accurately represent and inform City Council of all material facts or significant developments relating to real estate acquisitions under the jurisdiction of City Council. (Priority 2)

Management Response: Not Applicable to the Department

Recommendation #8: We recommend that the Council Policy set out in Recommendation 1 require the Independent Budget Analyst (IBA) to review the best practices checklist before City staff present the checklist to City Council committee and determine if staff completed the steps outlined in Recommendation 1. The IBA’s assessment should be conducted in writing and presented with sufficient time for City Council to review its conclusions. (Priority 1)

Management Response: Not Applicable to the Department

Recommendation #9: If determined to be necessary, we recommend that the Independent Budget Analyst (IBA) consider requesting budget approval from City Council for an as-needed consultant contract to assist the IBA in reviewing the City's best practices set out in Recommendation 1. The consultant could evaluate whether the checklist itself is fully developed and appropriate. The consultant could also evaluate proposed acquisitions and how well the City completed the checklist with regards to specific future acquisitions. (Priority 2)

Management Response: Not Applicable to the Department

Recommendation #10: We recommend that the Council Policy set out in Recommendation 1 require the Real Estate Assets Department (READ) to take all building purchases and leases that require City Council approval to the same City Council committee identified and designated in Recommendation 1. The Council Policy should also require that if the acquisition is not taken to the committee overseeing acquisitions, the City Administration should explain in writing why and the action taken by City Council should include an express waiver. (Priority 2)

Management Response: Agree

Agree: Similar to our response to recommendation #2, this recommendation is unnecessary as there is a Committee that currently provides this oversight, Land Use and Housing (LU&H). Real Estate staff is ultimately not in control of docketing, but we do concur that staff should make its best efforts to docket items for presentation at LU&H, prior to presenting to the full Council. Further, a memorandum requesting direct docket to City Council (bypassing committee) is already a requirement of the Council President and the memorandum includes why the request is being made.

Target Date: Management considers this recommendation to be implemented.

Thank you again for the opportunity to provide input and clarification on these issues. Staff are available for follow-up discussion with your team, as needed.

cc: Honorable City Attorney Mara Elliott
Andrea Tevlin, Independent Budget Analyst
Matt Vespi, Chief Financial Officer
David Nisleit, Chief, Police Department
Colin Stowell, Chief, Fire-Rescue Department
Alia Khouri, Deputy Chief Operating Officer
Kristina Peralta, Deputy Chief Operating Officer
Jeffrey Sturak, Deputy Chief Operating Officer
Matt Helm, Chief Compliance Officer
Jessica Lawrence, Director of Policy, Office of the Mayor
Randy Wilde, Senior Policy Advisor, Office of the Mayor
Matt Yagyagan, Deputy Director of Policy, Office of the Mayor
Rolando Charvel, Department of Finance Director and City Comptroller
Lakshmi Kommi, Director, Debt Management
Kyle Elser, Assistant City Auditor

Office of the City Auditor's Comments on the Response from the City Administration

We appreciate the City Administration's cooperation, assistance, and commitment to implement many elements of our recommendations. The insights and documentation they provided helped us thoroughly address our audit objectives and identify critical improvements that are needed to restore faith in the City of San Diego's (City's) ability to successfully execute major building acquisitions.

We disagree with the City Administration's assertion that the City should not have a required baseline checklist for major building acquisitions to ensure the City follows real estate best practices or explains for all decisionmakers on specifically why the City Administration chose not to follow a best practice. We respond to specific areas of disagreement below. Please note the Department of Real Estate and Airport Management (DREAM), below, was previously known as and is referred to in our report as the Real Estate Assets Department (READ).

We typically build flexibility into our recommendations to allow the City Administration to determine the best course of implementation. However, in the case of DREAM and major City building acquisitions, we found that a serious lack of policies and oversight caused the City to skip key steps in the acquisition process, and allowed the prior City Administration to leave out or misrepresent key information to City Council and the public. Given the costs and risks in major building acquisitions and the lack of policies and oversight that allowed these risks to come to fruition, we believe that a prescriptive process governing building acquisitions is necessary to minimize these risks to the City and the public. We concluded that acquisition processes should be more transparent, and the City would best be served by City Council establishing in policy the expectation that best practices be followed.

Recommendation 1. The City Administration disagrees that a checklist that prescribes the due diligence that should be conducted as part of an acquisition should be required. We recommended Council Policy establish a baseline checklist for major acquisitions because, as detailed in the audit report, we found that largely due to a lack of clearly defined roles and policies that a checklist would provide, acquisition decisions were essentially left up to the discretion of the prior City Administration and former DREAM Director. As a result, the prior City Administration failed to follow best practices and conduct essential due diligence on all five of the major building acquisitions we reviewed. Even basic steps such as obtaining an independent appraisal, building inspection, and asbestos inspection were often skipped.

Given that the City does not frequently make major building acquisitions, the checklist would ensure City decisionmakers and all departments involved in the process know what due diligence items, at minimum, should be expected from each major acquisition. This would help empower those with oversight roles to rely less on assertions made by the DREAM Director on what the City does and does not need to know about the buildings it is acquiring. The City cannot continue to simply rely on the DREAM Director and acquiring department to communicate what due diligence needs to be conducted. The City relied on the former DREAM Director and acquiring departments on the five transactions within our report and failed to conduct sufficient due diligence on each of the five transactions—costing the City millions of dollars. The time spent having to explain the few due diligence items in our baseline checklist that may not be necessary for each purchase is well worth avoiding the risk of a similar debacle in the future.

Recommendation 1g. The City Administration states that Recommendation 1g is unnecessary. We make this recommendation because, as detailed in Finding 3, City Council committees are important tools that

Performance Audit of the City's Major Building Acquisition Process

facilitate City Council oversight and can ensure City Council and the public have a chance to review, request additional information, and ask questions of staff proposing major building acquisitions before City Council has to vote on the acquisition. Establishing in Council Policy City Council's preference to have major building acquisitions reviewed by a designated committee would ensure that committee provides the expertise in the City's real estate necessary for each transaction. We note in Finding 3 that not all transactions went before the City Council committee designated to oversee real estate transactions or a City Council committee at all.

Recommendation 2. The City Administration disagrees with our recommendation that the Independent Budget Analyst (IBA) be notified and provided relevant information on building acquisitions at the time a building has been identified and prior to the start of negotiations. We stand by our initial recommendation. Under Recommendation 1, the IBA will review the checklist to verify for City Council that best practices in real estate have been completed and sufficient due diligence has been conducted. Verifying and analyzing information provided takes time and, as highlighted in Finding 3, the prior City Administration repeatedly did not provide the IBA and City Council with sufficient time to review the proposed acquisitions. Recommendation 2d ensures the IBA will be given adequate time to know when an acquisition is potentially forthcoming so the IBA can prepare its workload and potentially obtain the services of the as-needed real estate consultant set forth in Recommendation 9. Recommendation 2d expressly states the IBA would not be involved in the operations or management side of acquisitions.

Recommendation 4. The City Administration disagrees with our recommendation that the lead department should be responsible for ensuring contractors or advisors with significant input on real estate transactions have a contract with the City and have made appropriate economic disclosures. This recommendation is extremely important because at least two of the acquisitions in our scope involved an uncontracted real estate advisor with significant input on the City's real estate acquisition decisions. As we detail in Finding 1, the uncontracted advisor had significant input on the City's real estate acquisitions, including advising the former DREAM Director and Mayor directly on the acquisitions before the acquisitions were made. We believe this provides clarity on what we refer to as "significant input on real estate transactions" and should not be construed to mean consultants and advisors hired for narrow purposes such as IT consulting, construction management, or other areas the response lists.

The response also states it is redundant to have one department verify the work of another. In the case of the uncontracted real estate advisor that had significant input on the acquisitions of 101 Ash and Civic Center Plaza, no department did the work. The Mayor's Office did not ensure the advisor had a contract on file and made appropriate disclosures. DREAM presented the information to City Council and did not verify or disclose whether the advisor had a contract on file or whether the advisor had made appropriate economic disclosures. In Recommendation 1 in our report, we recommended the City create a checklist of best practices and that the lead department present the checklist to City Council. An item on the checklist is informing City Council of advisors such as this that worked on the acquisition and verifying that the advisors had contracts with the City and made appropriate economic disclosures so City Council is aware of potential conflicts of interest in the future. This would help ensure the situation is unlikely to happen again.

Recommendation 5. As mentioned under Finding 1, the City Administration disagrees with a checklist that prescribes due diligence that should be conducted. We refer the reader to our response under Finding 1, above, and would note again that the checklist would ensure City decisionmakers know what

Performance Audit of the City's Major Building Acquisition Process

due diligence items, at minimum, should be expected from each major building acquisition. The City cannot continue to simply rely on the DREAM Director and acquiring department to communicate what due diligence needs to be conducted. The time spent having to explain the few due diligence items in our baseline checklist that may not be necessary for each purchase is well worth avoiding the risk of a similar debacle in the future.

Recommendation 5a. The City Administration does not agree to contract for an appraisal prior to a purchase price being agreed upon. However, as illustrated in Finding 2, the prior City Administration failed to contract for an independent appraisal for the majority of buildings in our scope. In at least one instance, the City appeared to agree to a purchase price and then seek an appraisal to match the purchase price. We found other municipalities and real estate best practices direct the appraised value to drive purchase price, rather than the other way around. Failing to ensure independent appraisals early in the process has led to the City paying more than the appraised value or having to respond to complaints raised after purchasing the building and seek an independent appraisal to justify the use of funds.

Recommendation 6. As mentioned under Finding 1, the City Administration disagrees with a checklist that prescribes due diligence that should be conducted. We refer the reader to our response under Finding 1 above.

Recommendation 10. The City Administration's response states that Recommendation 10 has been implemented. Please refer to our response under Recommendation 1g.

Conclusion

We recognize that a new City Administration and DREAM Director are in place, and we in no way question the skills, expertise, judgment, and integrity of the officials in these positions. However, we believe the City Administration's planned approach continues to place the City at risk that key acquisition steps will be skipped, and decisionmakers such as the City Council would not have a point of reference as to what steps should likely have been performed. We believe that the results of recent building acquisitions should lead the City to implement strong controls that still provide flexibility, and we believe that our recommendations meet both of those criteria.

Performance Audit of the City's Major Building Acquisition Process
Office of
The City Attorney
City of San Diego

MEMORANDUM
MS 59

(619) 533-5800

DATE: July 20, 2021
TO: Andy Hanau, City Auditor, Office of the City Auditor
FROM: Mara W. Elliott, City Attorney
SUBJECT: Response to Performance Audit of Major Building Acquisition Process

INTRODUCTION

1 This memorandum provides our comments on the Performance Audit of the City's Major Building Acquisition Process (Audit) and responds to several recommendations in the Audit that contemplate future action or input from this Office. Many of the recommendations in the Audit are beneficial and, if implemented, will lead to improvements in the City's process of completing high-value building acquisitions. Nonetheless, the Audit reflects an incomplete investigation in some respects, makes certain unfounded or misleading conclusions, does not include recommendations that will truly address certain Audit findings, and offers one recommendation that is neither feasible to implement nor productive. These points were made verbally and in writing to the Auditor before the Audit was finalized and are reiterated below.

COMMENTS REGARDING AUDIT

Our main comments regarding the Audit can be summarized as follows:

- 2
- **The Audit is based on an incomplete investigation related to two downtown building acquisitions.** The Audit notes at page 48¹ that, with respect to the 101 Ash lease-to-own transaction (as with the nearly identical Civic Center Plaza transaction), the Auditor's Office did not interview the City's "special volunteer for real estate services" (Volunteer Broker), the former Real Estate Assets Department (READ) Director, the former Deputy Chief Operating Officer overseeing READ, or the former Mayor to whom each of these individuals reported. All played a critical role in those transactions and would possess direct knowledge of the acquisitions. The current City employees interviewed for the Audit were not directly involved and must therefore rely on their interpretation of evidence left behind by former officials. In addition, the Auditor's Office did not interview any Deputy City Attorneys involved in those transactions during the prior City

¹ All page references in this memorandum are to the "final draft" version of the Audit provided to our Office via email on July 13, 2021. We understand that the Auditor's Office may make minor additional revisions before issuing the final version of the Audit, in which case the page references in this memorandum may not match the final Audit precisely. We reserve the right to submit additional comments in response to any intervening changes in the Audit.

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Attorney administration. In the two years since problems began to surface at the 101 Ash building, the current administration of this Office has investigated the circumstances under which the parties orchestrated the two downtown building transactions, so that the City can pursue appropriate legal remedies to protect the interests of San Diego taxpayers. Unfortunately, the Audit does not provide any new meaningful information that would assist in this ongoing investigation. Without interviewing key witnesses and uncovering all of the specific facts underlying those two transactions, the Audit is an incomplete and inaccurate work product that fails to offer truly comprehensive recommendations that actually address the serious and potentially unlawful problems encountered in the transactions.

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- **The Audit fails to distinguish between the involvement of former and current administrations of this Office.** The Audit contains a glaring discrepancy in describing the respective roles of elected City administrations in the Civic Center Plaza and 101 Ash lease-to-own transactions. In numerous instances, including at pages 1, 13, 28, 32, 42, 46, 50, 55, 57, 61, and 68, the Audit emphasizes a clear distinction between the former and current Mayoral administrations in describing lapses that occurred leading up to the approval of those transactions. In stark contrast, the Audit neglects to point out the same distinction between the former and current City Attorney administrations, even though both the Mayor and City Attorney are citywide elected positions. The City Council's (Council) approval of the Civic Center Plaza agreement, and the signature of a Deputy City Attorney to approve that agreement as to form, occurred in early 2015 during the former City Attorney's administration. The same parties then utilized the same agreement for the 101 Ash transaction, changing only deal-specific terms such as building location and dimensions, lease commencement date, and monthly rent amount. A significant fact, omitted from the Audit, is that the Council's final approval of the 101 Ash agreement occurred at a public meeting on November 15, 2016, during the tenure of the former City Attorney. Although the signature of a Deputy City Attorney to approve the 101 Ash agreement as to form occurred shortly after the current administration of this Office began in December 2016, that signature, by law and by practice, simply carried out the Council's final policy decision to proceed with the transaction. The Audit points to no evidence that materialized between mid-November 2016 and early December 2016 that would have caused the incoming City Attorney to question either the wisdom or the legality of the 101 Ash transaction. This issue was repeatedly raised during the Audit, and consistently ignored by the Auditor.

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- **The Audit overlooks that the former City Attorney, like the Council, had no reasonable basis on which to raise "red flags" at the time of approval of the 101 Ash transaction.** At pages 16, 17, 49, and 55, the Audit cites a lack of evidence that READ or the former City Attorney disclosed legal risks to the Council in connection with the 101 Ash transaction. However, there is no evidence presented in the Audit that the former City Attorney knew the 101 Ash building's condition to be anything other than what City management and READ represented in written and verbal remarks to the Council. As the result of years of digging by the City Attorney's Office, the City is now aware that key

information about the 101 Ash transaction was misrepresented to and/or withheld from the public, the Council, the former City Attorney, and the Independent Budget Analyst (IBA). This malfeasance is likely inseparable from the fact that the Volunteer Broker, who was uniquely responsible for City staff's understanding of the acquisition, was simultaneously and secretly working for the seller. City staff's representations in advance of the Council's decision portrayed a building in "excellent condition" with "Class A (highest tier) office space," with only the need for a \$10,000 exterior power washing before move-in of City employees. City staff also provided the fiscal and logistical advantages of the agreement that were the basis of the staff recommendation to proceed with the transaction, and were incorporated into Ordinance O-20745 (Nov. 17, 2016), prepared by the former City Attorney for the Council's consideration of the 101 Ash transaction. Had the former City Attorney or the IBA known the building's true condition at the time of approval of the 101 Ash transaction, they could have appreciated the magnitude of the legal and financial risks and highlighted those risks for City decisionmakers. Presumably, the same could be said of the Auditor, whose job it is to protect the taxpayers by being an objective and independent check on the City's financial controls and performance². Like the Council, the City Attorney's Office and the IBA had neither the opportunity nor the expertise to conduct physical due diligence of the 101 Ash building. All these entities necessarily relied upon the expertise of City staff in evaluating the building's condition and performing appropriate due diligence, as well as the factual representations of City staff with respect to the building's condition. It is often the case that the Council, the City Attorney's Office, and the IBA are presented with select facts for purposes of moving a project along, especially projects on expedited timelines, as was the case here. It has taken the City Attorney's Office years to uncover basic facts that, if known or properly disclosed by the former Mayoral administration or its Volunteer Broker, would have changed the overall outcome of the Civic Center Plaza and 101 Ash building acquisitions. There is no rational basis for a Performance Audit, which is a diagnostic tool for understanding and improving City management practices, to have ignored this clear record and singled out the former City Attorney from among the many who were willfully misled.

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- **The Audit improperly suggests that the former City Attorney should have explained the plain meaning of "as-is" language to the Council.** At pages 16 and 17, the Audit appears to ascribe fault to the former City Attorney for failing to explain in writing to the Council that the "as-is" language in the 101 Ash agreement means the City would agree to accept the building in its then-current condition, with all defects. This is an absurd and baseless suggestion for at least four reasons. **First**, the "as-is" language is prominently displayed, in ALL CAPITALIZED text, in Section 1(b) on pages 1 and 2 of the 101 Ash agreement.³ The City's decisionmakers, elected by district based on capability and skill

² The Audit Committee never discussed the Ash Street or Civic Center Plaza acquisitions, nor did the Auditor mention concerns – "red flags" – to the Audit Committee, during or after the acquisitions. This Audit came at the request of former Councilmember Bry during the fall of 2020.

³ Additionally, Section 6(c) on page 10 of the agreement confirms, in **bold**, ALL CAPITALIZED text, that the City would absorb the risk of all claims with respect to any environmental contamination and related remediation of any

set, are expected to review the material provisions of a City contract (especially provisions that are emphasized on the very first page of the contract), and raise questions if they have reservations or are confused by the contractual language, before deciding whether to approve a contract. **Second**, the “as-is” language in the 101 Ash agreement is plain and unambiguous on its face, and is accompanied by equally plain language stating that the City was assuming “all risk” related to the property. It is hard to be more clear. No specialized legal knowledge or expertise in real property transactions is required to appreciate the gravity of this simple and brief contractual provision. **Third**, “as-is” language of the type contained in the 101 Ash agreement is frequently included in real property acquisition contracts at the insistence of the seller or landlord. The “as-is” language is not unusual or necessarily problematic on its own, but may pose significant risk when either the seller fails to disclose to the buyer known information regarding defects in a building’s condition, or the buyer fails to conduct appropriate due diligence corresponding to the buyer’s intended future use of the building. There is nothing atypical about the “as-is” language in the 101 Ash agreement that would have caused the former City Attorney to feel compelled to provide an explicit written explanation to the Council. Nor does the Audit present evidence that any Councilmember struggled to understand the meanings of “as-is” or “all risk.” **Fourth**, both READ and the City Attorney’s Office disclosed in writing to the Council that, upon the building acquisition, the City would undertake all responsibility for operating, managing, maintaining, and repairing the 101 Ash building. The staff report plainly disclosed: “The City will be responsible for all operating expenses (including utility expenses, building management and maintenance and repair).” Similarly, Ordinance O-20745, prepared by the former City Attorney, confirmed the City would be responsible for all operating expenses of the building in accordance with the proposed 101 Ash agreement. Those written disclosures to the Council more than capture the basic meaning and consequence of the “as-is” language in the agreement.

- **The Audit improperly suggests that the former City Attorney failed to point out the risk that the City’s broker would fail to disclose his dual agency role in two downtown building acquisitions.** The Audit includes examples of legal risk, in footnote 7 at page 16, that could arise in connection with the City’s acquisition of a building, including a risk that the broker would fail to disclose a dual agency role in the transaction. The Audit further states: “Legal review can help mitigate these risks.” It is ludicrous to imply that the former City Attorney would have been in a position to know or discover, before City management expedited the Civic Center Plaza and 101 Ash transactions for Council approval, that the City’s Volunteer Broker for those transactions had not only failed to disclose his dual agency role but also had negotiated secret brokerage commissions to be paid by the seller amounting to more than \$9.4 million. The Volunteer Broker reported directly to the former Mayor – a separate branch of

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contaminants (such as asbestos) at the building. We also note that, over 1.5 years before the Council approved the 101 Ash agreement, the Council approved the Civic Center Plaza agreement, which contained the same “as is” and “environmental risk” language in prominent text.

government – and was empowered by the former Mayor to represent the City in these negotiations. The City Attorney’s Office was not included in meetings between the former Mayor and the Volunteer Broker, whom the former Director of READ (who was not interviewed by the Auditor) described as having “a very strange liaison and loyalty to each other that transcended any relationships with staff. Everyone was aware of that.”⁴

- **The Audit fails to identify extenuating circumstances that prevented the Palm Avenue hotel from being used for its primary intended purpose.** A table is included on page 26 of the Audit to support the Audit’s narrative that certain buildings acquired by the City have not been used for their primary intended purpose. Along these lines, the table indicates that the Palm Avenue hotel is being used for temporary housing of homeless families, not for its originally intended purpose of temporary housing for San Diego Misdemeanants At-Risk Track (SMART) program recipients. However, the Audit neglects to mention an important fact that was explained to the Auditor’s Office – a fact that contradicts the Audit’s narrative. The City Attorney’s Office and the prior Mayoral administration entered into a Memorandum of Understanding in mid-2020, which we provided to the Auditor, for the Palm Avenue hotel to be used temporarily in addressing the aggravated homelessness crisis associated with the sudden onset of the COVID-19 pandemic and, after this temporary use, would revert to its primary intended use. This MOU demonstrated prudent crisis management and flexibility on the part of City management, allowing the City to use an available asset to help address an unprecedented global pandemic. The Audit ignores the truth and misleads its readers by citing this decision as a purported example of mismanagement on the City’s part.

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RESPONSES TO RECOMMENDATIONS IN AUDIT

Recommendation 1 in the Audit calls for READ, in consultation with the IBA and this Office, as well as other City departments as needed, to create a new or amended Council Policy for Council approval that requires a best practices checklist for building acquisitions, including certain specified components. We agree to assist READ and other City departments in preparing this new or amended Council Policy on a reasonable timeline. We recommend, however, that the City retain a qualified independent consultant with substantial experience in the real estate industry to assist the City in formulating the best practices checklist, which could prove extremely valuable in protecting the City’s interests during future high-value real property transactions, even if some delay in completing the new or amended Council Policy results.

Recommendation 2 states, in part: “When drafting the Council Policy set out in Recommendation 1, we recommend that [READ], in consultation with the [IBA], City Attorney’s Office, and other departments as needed, create an Administrative Regulation to establish clear roles and responsibilities for City departments involved in the acquisition process or with expertise to contribute to the acquisition process.” We agree to assist READ and other City departments in implementing Recommendation 2 on a reasonable timeline, and we reiterate that the City should retain a qualified independent consultant to help guide this effort.

⁴ “What Faulconer Knew Is Now the \$9M Question,” Voice of San Diego, June 29, 2021.

Recommendations 1(h) and 2(c) call for the City Attorney's Office to present a "written analysis of the significant legal risks of the contract" before the Council is asked to consider any proposed contract for a building acquisition valued at greater than \$5 million. Although we agree in principal part, we reserve discretion to determine the most effective manner of communicating with our client and to evaluate which circumstances rise to the level of a "significant" legal risk that warrants express disclosure.⁵ We can commit to inserting into the staff report language confirming our review of the contract and pointing out any known significant legal risks. In certain situations, however, we may elect to provide legal advice through a confidential legal memorandum or other mode of communication. We support the provision of full transparency and disclosure to the Council and the public through the staff report and the docket backup materials. And, as always, we are available for individual briefings or meetings with Councilmembers in advance of the Council's consideration of proposed transactions. Further, our Office is always available to answer questions about any City transaction in which we are involved at Committee and at Council meetings. It is imperative that the City's decisionmakers review all presented materials, and ask questions regarding any areas of concern, before deciding whether to approve building acquisitions.

Recommendation 7 states: "We recommend that the [IBA], in consultation with the City Attorney's Office, create and bring forward to City Council for approval a section to be added to the San Diego Municipal Code to provide an enforcement mechanism for Charter Section 32.1, to ensure that City staff accurately represent and inform City Council of all material facts or significant developments relating to real estate acquisitions under the jurisdiction of City Council." Despite our request, the Auditor's Office has refused to clarify the intent of Recommendation 7 as to the preferred enforcement mechanism for any demonstrated violation of Charter section 32.1. More importantly, it is unlikely that an enforcement mechanism could be crafted in the Municipal Code in a manner that is enforceable and would survive a "vague and ambiguous" challenge from any alleged violator. City departments already have a critical enforcement tool available to them: they may discipline and terminate employees who fail to perform or who engage in any concealment of material facts or unexcused negligence. In sum, Recommendation 7 is neither feasible to implement nor productive. We encourage Mayoral administrations to foster a spirit of full disclosure and transparency among City department employees regarding material facts that may affect the viability or wisdom of proposed transactions, and we encourage all Councilmembers to carefully review the docket materials provided to them and raise appropriate questions with City staff and our Office.

Finally, as described above, we observe that the Audit appears to ascribe fault to the former City Attorney for not disclosing certain legal risks related to the Civic Center Plaza and 101 Ash building acquisitions before the Council approved those transactions in 2015 and 2016, respectively. We believe the Audit imposes a wholly unrealistic expectation on the City Attorney's Office that does not reflect the proper role of a legal advisor in the City's current governance structure. Under the City's "Strong Mayor-Strong Council" form of government, READ and various other City departments report directly to the Mayor, not to the City Attorney.

⁵ We note that virtually every proposed building acquisition will involve some level of risk or potential loss.

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Andy Hanau, City Auditor

July 20, 2021

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As a result, the City Attorney's Office has no authority under the San Diego Charter to compel Mayoral department employees to divulge their work product, to direct or oversee the actions of Mayoral department employees, or to ensure that Mayoral department employees undertake a proper due diligence investigation of a building's condition and disclose the results of that investigation to the City's decisionmakers. If, as is implied by the Audit, the Auditor's Office expects the City Attorney's Office to carry out a vastly expanded role with respect to proposed City transactions, then the Auditor's Office should amend the Audit to include a new recommendation (such as a proposed Charter amendment) that would equip the City Attorney's Office with additional power needed to effectively perform that outsized role. To that end, it is evident to this Office that the "Strong Mayor-Strong Council" form of government has discouraged communication among the City's three branches of government, rather than promote it, and our residents are worse off as a result. Equipping the City Attorney's Office with new authority may be one way to address this concern.

CONCLUSION

While we are disappointed with the Auditor's failure to review all pertinent information and his reliance on false assumptions, we appreciate that many of the recommendations in the Audit are productive and, if implemented, will lead to improvements in the City's process of completing high-value building acquisitions. We look forward to working with City staff and the IBA to implement Recommendations 1 and 2 in the Audit on a reasonable timeline.

MARA W. ELLIOTT, CITY ATTORNEY

By 

MWE:sne

Doc. No.: 2716572

cc: Jay Goldstone, Chief Operating Officer
Andrea Tevlin, Independent Budget Analyst

Office of the City Auditor's Comments on the Response from the City Attorney's Office

We appreciate the City Attorney's cooperation during our audit and overall support of many of our recommendations. We believe full implementation of our recommendations will improve the City of San Diego's (City) major building acquisition process in the future, including by clearly delineating the City Attorney's Office's role in reviewing major building acquisitions.

We disagree with the City Attorney's characterization of our audit as an incomplete investigation. We conduct independent performance audits that follow Generally Accepted Government Auditing Standards, where we address specific audit objectives based on sufficient and appropriate evidence. The objective of our audit was not to partner with the City Attorney's Office in its ongoing investigations and lawsuits related to the City's building acquisitions. The objectives for this audit were as follows:

- To determine if the City followed policies and best practices when purchasing buildings or entering into lease agreements worth more than \$5 million from FY2015 to FY2019; and
- To determine if the City has sufficient governance mechanisms for oversight of purchases and lease agreements worth more than \$5 million from FY2015 to FY2019.

We made 10 recommendations based on our independent evaluation of the evidence that will help ensure the City follows best practices when acquiring major buildings and avoid the types of failures that have characterized the City's recent building acquisitions.

We are commenting on the City Attorney's response to our audit to provide clarity and perspective. Rather than comment on all areas of the response that we believe are inaccurate or misleading, we have summarized our comments by number below that correspond to the numbers placed in the margin of the City Attorney's response.

1. The response indicates that this report is incomplete and makes unfounded or misleading conclusions, which is not accurate. Although we were unable to compel some former key City officials involved in the building acquisitions transactions to speak with us, we did meet with several former and current City officials that were involved with, and were knowledgeable about, what transpired. In addition to conducting more than 40 interviews, we collected further evidence via review of City policies and procedures, email records, staff reports and presentations to the City Council; review of investigative reports on the 101 Ash transaction such as the Hugo Parker report; and benchmarking with building acquisition practices used by other government agencies. We were able to gather sufficient evidence to produce a complete report, which does not contain any misleading or unfounded conclusions and identifies critical control weaknesses that need to be addressed.
2. The response again indicates that we only interviewed current City employees that were not directly involved, and we relied on their interpretations of evidence left behind by former officials. This again is inaccurate because in addition to current City officials that were involved in the transactions, we interviewed several former high-ranking officials including the former Mayor's Chief of Staff, the former Mayor's Deputy Chief of Staff/Chief of Policy, two former Chief Operating Officers, the former Assistant Chief Operating Officer, and the former Chief Financial Officer. We attempted to interview the former City officials the response mentions, in addition to the uncontracted real estate advisor, but we did not have a way to compel them to answer our

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questions. The City Auditor does not have the ability to subpoena individuals to interview. The City Charter requires current City employees to provide all requested information to the City Auditor, and although the City Charter also authorizes the City Auditor to summon former City officials and other persons to answer questions, we discovered there is no enforcement mechanism to require non-employees to cooperate and make full disclosure of all pertinent information.

3. The response indicates that our audit does not provide any new meaningful information that would assist in this ongoing investigation, and it fails to offer truly comprehensive recommendations that actually address the serious and potentially unlawful problems encountered. As stated above, our objective was not to partner with the City Attorney's Office in their ongoing investigations and lawsuits related to the City's building acquisitions. We had two objectives which our report thoroughly addresses based on our evaluation of sufficient and appropriate evidence. We made 10 comprehensive recommendations that, when implemented, will help ensure the City follows best practices when acquiring major buildings and informs the City Council and the public of all material facts, including significant legal risks. Our recommendations will help avoid major building acquisition failures that cost taxpayers millions of dollars, disrupt City operations, and seriously damage the City's reputation in the eyes of the public.
4. The response indicates that our audit fails to distinguish between the involvement of the former and current administration of the City Attorney's Office. However, in Finding 1 we speak generally about the City Attorney's Office's role in the City regarding major building acquisitions—the majority of which were acquired under the current City Attorney. Our report specifically only uses the 101 Ash acquisition as an example in this section, and the 101 Ash building was acquired during the current City Attorney's administration. In Finding 3, we discuss the City Attorney's Office's role in the 101 Ash acquisition, which, again, was acquired during the current City Attorney's administration. While it appears to be true that the vast majority of the legal work on the 101 Ash transaction was completed under the prior City Attorney, it is not factually accurate to refer only to the prior City Attorney, because the final signoff occurred after their term. We acknowledge Civic Center Plaza was acquired during the previous City Attorney's administration. However, at no point in the report do we directly discuss the City Attorney's role in the Civic Center Plaza acquisition. Therefore, we felt it was most accurate to describe in the report the role of the City Attorney's Office in general, and not to differentiate between the roles of the former City Attorney versus the current City Attorney.
5. The response indicates that our audit overlooks that the former City Attorney had no reasonable basis on which to raise "red flags" at the time of approval of the 101 Ash transaction. We disagree with this assertion. The City Attorney's Office should have had access to all the information and reports used by City Management to support their statements related to the condition of the building. A review of that information would have shown that City Management was relying on the seller's building assessment information and City Management did not conduct their own building condition assessments. Knowing that the contract had an "as-is" clause and that City Management did not conduct an independent assessment should have raised a red flag prompting a disclosure of the risks involved to City Council. Officials from other cities and other government entities we interviewed indicated their real estate process included involving the city's or entity's attorneys throughout the acquisition, with the attorneys reviewing legal documents, understanding due

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diligence conducted, and minimizing the legal risk that an as-is clause may impose on the acquisition.

Additionally, another red flag is that the 101 Ash contract expressly states that the City is “not relying on any representation or warranty by Landlord with regard to the condition of the Premises,” when in reality, the City was relying almost exclusively on building condition assessments provided by the seller.

The City Attorney’s Office could have requested to review the due diligence documents to help determine the legal risk posed by these contract provisions. The City Attorney notes that City Management may not provide the City Attorney’s Office with requested information. In that case, if the City Attorney’s Office was denied access to information and reports used by the City Administration to support their statements related to the condition of the building, the City Attorney’s Office also could have raised this issue as an item of note to City Council, as the City Attorney’s Office is responsible for providing legal counsel to City Council—a role it would be unable to adequately perform without such documentation.

We note that our recommendations address this exact situation, in part to assist the City Attorney’s legal review. Specifically, we recommend that the City create a checklist of required due diligence items, and that all supporting documents be made available to the City Council, Independent Budget Analyst, and City Attorney to help facilitate their evaluation of the acquisition proposal.

6. The response suggests that the City Auditor could have had a role in providing a warning related to the risks associated with the purchase of 101 Ash. This is incorrect. The City Charter requires the City Auditor to follow Government Auditing Standards, which does not allow an auditor to take on the role of management, like consulting and participating in a decision to purchase a building, and then subsequently audit that transaction. That is why the Office of the City Auditor does not engage in consulting and participate in management decisions, because it would significantly limit the Office’s ability to conduct audits.
7. The response indicates that our audit improperly suggests that the former City Attorney should have explained the plain meaning of “as-is” language to the City Council. We disagree that the information in the audit report is improper—the City Attorney should have explained the risk of the “as-is” language to City Council. Our review of criteria related to building acquisitions showed that it is a best practice for attorneys to advise their clients on the legal risks associated with the terms of a contract. Further, City Attorney’s Office staff told us in a documented interview that their advice is that if the City is going to take on the risk of the “as-is” clause, it is important to do the due diligence so we know what risks we are taking on. Because City Management did not conduct an independent building assessment to show the City Attorney’s Office, we appropriately concluded that the City Attorney could have disclosed the heightened risk associated with the “as-is” clause when independent due diligence is not conducted.
8. The response states that our audit implies the former City Attorney would have been in a position to know that the City’s real estate advisor had negotiated to be paid \$9.4 million by the 101 Ash and Civic Center Plaza seller. Our report does not state that the City Attorney failed to disclose the City

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advisor's dual agency role. The footnote referred to merely gives examples of legal risks attorneys should consider in building acquisitions, including the risk associated with dual agency roles.

9. The response states that our audit misleads readers by stating that the Palm Avenue Hotel is not being used for its originally intended purpose—temporary housing for San Diego Misdemeanants At-Risk Track (S.M.A.R.T.) program recipients—without mentioning why this is the case. While we do state that the building is currently being used to house homeless families, we also wish to note that the building was available to house families experiencing homelessness during the COVID-19 pandemic because it was not being used for the S.M.A.R.T. program recipients more than two years after it was acquired by the City. The City acquired the building in 2017 and told City Council it would be open in 2018; however, the building was vacant and available for use in 2020. We did not include this detail in the report, as it did not materially impact our main conclusion, which is that many buildings the City acquires sit vacant for periods of time or not used for their intended purpose.

Recommendations 1 and 2. The response indicates that the City Attorney recommends that the City retain a qualified independent consultant with substantial experience in the real estate industry to assist the City in formulating a best practices checklist. We did not specifically recommend that the City use a consultant to develop the checklist, but support the City using whatever means available to best implement our recommendations.

Recommendation 7. The response states our office has refused to clarify the intent of Recommendation 7 as to the preferred enforcement mechanism for any demonstrated violation of Charter Section 32.1. Our office disagrees with this assertion. We have informed the City Attorney's Office and the Office of the Independent Budget Analyst that they could model the enforcement mechanism to reflect language of the Improper Influence clause in Chapter 2, Article 2, Section 22.0711 of the San Diego Municipal Code, which makes it a misdemeanor to coerce, fraudulently influence, manipulate, or mislead the City Auditor in an audit. However, we leave it open to their interpretation and legal expertise as to how to best implement this recommendation. It is true that the recommendation, once implemented, may be difficult to enforce. However, the current City Charter language is insufficient to deter misleading City Council and lacks enforcement mechanisms outside of the City Administration's chain of command. Given the incomplete and misrepresented information City Council and the public received on the 101 Ash acquisition, we believe the City should strengthen enforcement mechanisms to the extent possible.

Conclusion

Again, we appreciate the City Attorney's Office's cooperation with us during the audit and support of many of our recommendations. Overall, however, we disagree with assertions that our report is incomplete and relies on false assumptions. As we state in our Objectives, Scope, and Methodology, we conducted this audit in accordance with Generally Accepted Government Auditing Standards, addressed our objectives based on the evaluation of appropriate and sufficient evidence, and made 10 recommendations that will help ensure the City follows best practices when acquiring major buildings in the future.



THE CITY OF SAN DIEGO

M E M O R A N D U M

OFFICE OF THE INDEPENDENT BUDGET ANALYST

DATE: July 22, 2021

TO: Andy Hanau, City Auditor

FROM: Andrea Tevlin, Independent Budget Analyst

SUBJECT: IBA response to recommendations in the Performance Audit of the City's Major Building Acquisitions Process

This memorandum provides responses to the recommendations directly relating to our Office.

Recommendation #7

We recommend that the Independent Budget Analyst, in consultation with the City Attorney's Office, create and bring forward to City Council for approval a section to be added to the San Diego Municipal Code to provide an enforcement mechanism for Charter Section 32.1, to ensure that City staff accurately represent and inform City Council of all material facts or significant developments relating to real estate acquisitions under the jurisdiction of City Council.

IBA Response: Agree with recommendation

While the IBA stands ready to implement this recommendation, we must rely on the Office of the City Attorney's counsel to develop a feasible and legal enforcement mechanism for inclusion into the San Diego Municipal Code in support of Charter Section 32.1. In preliminary conversations with the Office of the City Attorney regarding this recommendation, they have expressed doubt that a legal enforcement mechanism can be developed. In their response to the City Auditor, they conclude that "Recommendation 7 is neither feasible to implement nor productive". We recommend that their position on this recommendation be discussed at the Audit Committee meeting on July 28, 2021. It is not possible to provide a timeframe for completion without further clarification.

Recommendation #9

If determined to be necessary, we recommend that the Independent Budget Analyst (IBA) consider requesting budget approval from City Council for an as-needed consultant contract to assist the IBA in reviewing the City's best practices set out in Recommendation 1. The consultant could evaluate whether the checklist itself is fully developed and appropriate. The consultant could also evaluate proposed acquisitions and how well the City completed the checklist with regard to specific future acquisitions.

IBA Response: Agree with recommendation

The IBA will assess and consider whether it would be helpful to retain an as-needed consultant with unique expertise to help our Office evaluate the best practices checklist discussed in Recommendation #1. When a building purchase or lease agreement is proposed for City Council approval, we would also consider whether an as-needed consultant could help our Office better evaluate the adequacy of management's responses to checklist items.



Andrea Tevlin
Independent Budget Analyst