

**Minute Item
86**

06/26/06
G05-07.5
J. Lucchesi
C. Fossum
D. Mercier
R. Richardson

**CITY OF REDONDO BEACH
(TRUSTEE)**

Regular Item 86: The Commission listened to a staff presentation pertaining to the consideration of a financial review and legislative grant to the City of Redondo Beach. The Commission decided to postpone this item until various issues could be further investigated.

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**REPORT ON A FINANCIAL MANAGEMENT AUDIT
OF THE CITY OF REDONDO BEACH'S TIDE LANDS TRUST**

Trustee

City of Redondo Beach
415 Diamond Street, P.O. Box 270
Redondo Beach, CA 90277-0270

Introduction

On November 29, 2004, California State Lands Commission (CLSC or the Commission) staff received a complaint alleging a number of illegal activities by the city of Redondo Beach (City) and its redevelopment agency including misuse of public trust funds by the City. In response to the complaint CSLC staff conducted a financial review investigation (audit) of the City's granted tide and submerged lands trust fund accounts. The scope of the review included an analysis of revenues and expenditures for a five-year period ending June 20, 2004, with a special emphasis on the Harbor Center Project from inception to present.

The financial review conducted by staff involved only those allegations related to the tidelands trust funds and staff believes that the evidence uncovered does not warrant further action by the Commission regarding the allegations of criminal conduct made in the original complaint involving the tidelands. Staff is informed that the allegations of illegal activities by the City have been referred to the offices of the Los Angeles District Attorney, California Attorney General and the Federal Bureau of Investigation. The allegations did, however, lead staff to uncover several separate areas within the financial management of the City's granted tide and submerged lands which were in need of explanation and staff believes remediation. The areas of improvements recommended by CSLC staff revolve around two particular transactions: the Kincaid's Restaurant lease arrangement and the Harbor Center

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Redevelopment Project. These two transactions are more fully described below after addressing the specific allegations raised by the initial complaint.

Background

The Legislature first granted certain tide and submerged lands to the city of Redondo Beach in 1915 pursuant to Chapter 57. The grant was subsequently amended by Chapter 1555, Statutes of 1971. The effect of the legislative grant was to create a trust in which the City is trustee, the State the trustor, and the people of the State the beneficiaries of the trust. As trustee, the City has a fiduciary responsibility to the statewide public to manage these tide and submerged lands in accordance with the public trust doctrine and the granting statutes. The legal consequence of this relationship is that the proper use of the tidelands and tideland revenues is a matter of state law.

The land uses authorized by the grant include the traditional triad of public trust uses, including waterborne commerce, navigation and fisheries, but also include other uses, such as marine oriented public recreation, commercial and industrial uses, open space and wildlife habitat uses, and uses which are necessarily incidental in the promotion and accommodation of public trust uses. The grant specifically requires that the State Lands Commission approve any capital expenditure of public trust revenues proposed by the City, which exceeds \$250,000.

Specific Allegations

The submitted complaint alleged a number of issues involving City activities outside of the scope of the Commission's review of tidelands trust matters and those areas were not investigated by staff. The following allegations of misuse of trust funds, within the scope of the Commission's review, were made and investigated:

1. "During FY 2002-2003 and FY 2003-2004 funds were illegally transferred from the tidelands fund to the City's general fund and to the Community Redevelopment Agency."
 - CSLC staff found no evidence that tidelands funds were illegally transferred to the City's general fund or to the Community Redevelopment Agency (CRA or Agency). While it is true that funds were transferred from the Tidelands Fund to the City's General Fund, these funds are transferred annually to cover certain overhead charges for administrative services conducted by city staff involving the City's tidelands. CSLC staff reviewed the City's method for determining cost allocations and found no evidence that funds were being transferred illegally. The transfer of funds to the Redevelopment Agency is discussed in more detail below.

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2. "The City's Comprehensive Annual Financial Report (CAFR) listed \$11,974,561 in Harbor Tidelands Retained Earnings for FY 2001-2002. The CAFR for FY 2002-2003 did not list any retained earnings. The category was eliminated from the CAFR. Where did the money go? The City's Public Finance Authority (PFA) also ceased to be reported as a separate entity, despite the fact it is a joint powers entity (a legally separate component) of the City of Redondo Beach and the Community Redevelopment Agency."
 - The Harbor Tidelands Retained Earnings did not vanish between 2002 and 2003. The Governmental Accounting Standards Board (Board) recently adopted new reporting criteria known as GASB 34. The Board required that cities be in compliance with this standard by 2002. The Retained Earnings category had previously included the value of certain specified assets. The new standards provided that both the depreciated value and replacement costs of assets be shown and be identified as Net Assets. While, unrestricted retained earnings decreased from \$11,796,190 in 2002 to \$10,879,770 in 2003, this was due to the reclassification to be in compliance with GASB 34 and was in fact a non-cash journal entry. Furthermore, overall net assets increased by \$1,128,514 during this time period.
3. "The City's CAFR for FY 2002-2003 contains a notation that the CRA received a Fund Transfer Advance of \$5,570,144 from the Tidelands Fund. This is illegal. There is no Redevelopment area within the Tidelands area."
 - According to the City's CAFR for FY 2002-2003, it is actually the Redevelopment Agency that is shown as owing the \$5,570,144 (accounts receivable) to the Tidelands Fund. This involves a transaction initially approved by the Commission in 1983. The details surrounding this transfer are described below in connection with the Harbor Center Project.

As stated previously, while the financial review did not substantiate any of the specifically alleged complaints, staff did find certain instances where the City's management of its granted tidelands was in need of explanation, clarification and improvement. These specific instances include the Harbor Center Project and Kincaid's Restaurant.

Harbor Center Redevelopment Project

Background

The Commission on several occasions has reviewed and approved the expenditure of tidelands trust revenues by the City for projects involving proposed capital expenditures in excess of \$250,000 in tidelands funds as provided for in Chapter 1555, Statutes of 1971. For example, as background, in 1979, the City first discussed with Commission staff the concept of constructing a parking facility (Plaza Parking Structure) on uplands adjacent to the harbor to provide needed parking for King Harbor visitors. The City submitted in February 1981 and the Commission approved on April 7, 1981 (Item #20) the expenditure of \$4 million to construct a 325 space parking structure, with a public plaza/park on the upper level, to augment the harbor's existing 1100 space parking structure (Exhibit B, Parcel 1).

Two years later, the City's proposal to acquire an additional nearby property (a portion of the Harbor Center Project) for additional parking and landscaped areas for King Harbor was approved by the Commission as Item #17 on February 28, 1983 (Exhibit B, Parcel 2). The CSLC approved \$3.5 million for the acquisition of land and the construction thereon of a parking structure, which became known as the public portion of the Harbor Center Project. Subsequently, on September 22, 1983 and on February 28, 1985, the CSLC approved two, respective, 18-month extensions for the City to comply with the time authorized for the acquisition of the land and conveyance to the trust from August 28, 1983 to August 27, 1986.

The Harbor Center Project, a hotel, retail and parking complex project, was developed by the City's Redevelopment Agency. The Harbor Center Redevelopment Plan was originally adopted on December 1, 1980. A "Disposition and Development Owner Participation Agreement" (DDA), between the City of Redondo Beach, the Redondo Beach Redevelopment Agency (Agency), and Triangle Associates LP (Developer), had been entered into on August 22, 1983. The purpose of the DDA was to effectuate the redevelopment plan for the Harbor Center Project. The project, as submitted to the CSLC in 1983, shows the project as divided between "public" and "private" portions (Exhibit B). The public portion as proposed was a public parking structure and an open landscaped area; the private portion was to be a 353-room hotel, retail space and a portion of the parking structure.

In the process of acquiring the parcels within the Harbor Center Project area, the City became involved in a lengthy eminent domain lawsuit concerning several of the parcels, *City of Redondo Beach v. Ken Coats, et al* (Los Angeles Superior Court Case No. C523554). The initial estimated cost by the Redevelopment Agency for the condemnation was approximately \$6 million. The court issued an order of

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immediate possession for the majority of the Harbor Center Project property on April 1, 1985. The lawsuit was not formally and finally resolved until May 22, 1991, when the Los Angeles Superior Court entered a judgment awarding \$9,564,500 plus interest to the defendants (2 of the 17 parcels were not involved in the lawsuit). According to the City the total condemnation and acquisition costs exceeded \$12 million. On June 25, 1991, fee title to a portion of the land underlying the public parking structure was conveyed from the Redevelopment Agency to the City as trustee for the tidelands trust; this conveyance took place nearly five years beyond the extended deadline of August 27, 1986. Due to the litigation delay, actual acquisition costs to the trust amounted to over \$5 million (\$3.5 million approved by the Commission plus accrued interest).

In 1988, a series of natural disasters befell Redondo Beach's King Harbor, including two major storms, one in January and the other in April. Then a major fire in May destroyed over 50% of the Redondo Beach Pier. Total damage from the disasters amounted to approximately \$9.2 million. There was also a loss of rental income of \$1.5 million from businesses located on the pier.

On June 5, 1990, a City advisory vote was held to determine whether to rebuild the Pier and under what conditions. The electorate voted for rebuilding the Pier, but chose not to use City general funds for reconstruction. Because the tideland trust had been depleted by the disasters and the ongoing Harbor Center Project eminent domain lawsuit, the City decided the best source of funding available to supplement bond and grant funds obtained to rebuild the Pier was through the Redevelopment Agency.

The source of funding used by the Redevelopment Agency was a "tax increment" from the Harbor Center Project. A tax increment is based on the additional appreciated value of the property benefiting from redevelopment. More specifically, tax increment financing is calculated based on the assessed value of the project area less the assessed value at the time the redevelopment plan was adopted. This incremental assessed value is then multiplied by the 1% property tax rate resulting in the tax increment. These additional tax revenues are distributed among entities entitled to property taxes based upon statutory formulas provided for in redevelopment law.

The ability of the Redevelopment Agency to collect this tax did not occur until December 1989 when the Redevelopment Plan was amended to add a tax allocation provision, and also authorized the Agency to pay the costs of certain public improvements necessitated by the 1988 natural disasters. Subsequently, a Cooperation Agreement, entered into by the City and Redevelopment Agency on

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June 19, 1990, established that the \$5 million plus provided by the Tidelands Fund and \$869 thousand provided by the City's Harbor Uplands Fund to the Redevelopment Agency under the DDA, for the acquisition of land for the Harbor Center Project, be repaid to those funds and that the source of funds to be used would be the "Available Project Tax Increment" -- meaning the tax increment generated by the Harbor Center Project area and paid to the Agency. To satisfy redevelopment law requirements of establishing a debt to be repaid by the tax increment and provide an additional source of funds to repay the costs of the redevelopment of the Harbor Center Project, the City restructured the \$5 million plus investment by the trust as a debt and provided that the debt accrue interest at the rate paid by the State/Local Agency Investment Fund. This debt was established on January 1, 1990; the balance of this tidelands trust debt as of June 30, 2005 was nearly \$5.9 million.

The Harbor Center Project tax increment revenue currently continues to pay the interest and principal on the Pier bonds and also secures the subordinate Tidelands Fund and Harbor Uplands debt. The Redevelopment Agency has not paid any amounts on principal or interest into the Tidelands Fund or Harbor Uplands Fund, to retire the Harbor Center debt, since June 1993. Due to a downturn in the local economy with the collapse of the Southern California aerospace industry local property, values plummeted and the Harbor Center valuation and tax increment was reduced by approximately two-thirds. There is also a negative motivation to repay the Tidelands Fund debt because the Redevelopment Agency will lose the tax increment when the redevelopment debt is extinguished. They instead have been paying off the Pier Bond debt with the tax increment revenue. Last year the Harbor Center property sold and once again its value has been re-assessed. This time the value more than doubled, but is still less than in 1989. Although the Redevelopment Plan's time limit to collect taxes is December 2030, because the debt predates 1994 it may be extended. It is estimated by the City's consultant that the low rate of property value appreciation in the area and with an assumed 4.78% interest rate on the debt, the Redevelopment Agency will be limited in its ability to repay the bonds, the Tidelands Trust Fund and the Harbor Uplands Fund before 2050.

Currently, the City's Tidelands Fund receives a fixed rental rate of \$12,000 per year for 50 years, pursuant to a "Ground Lease" for the public portion entered into on May 31, 1985. The Harbor Center Project's "public" portion of the complex consists of a section of the parking facilities plus commercial/retail space that was constructed on top of the parking facility. The retail space is currently occupied by "Gold's Gym." Gold's Gym does not pay rent to the Tidelands trust as it is a sub-lessee of the tenant/developer.

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Analysis

CSLC staff review of the Harbor Center Project focused on three primary aspects: (1) the City's failure to comply with the specific timeframes, dollar amounts, and express acquisition authorization of the Commission's approvals; (2) the rate of return received for the lease of the public portion of the Harbor Center Project; and (3) the occupation of a portion of the parking structure by Gold's Gym.

Commission's Requirements

The Commission, in its 1983 review of the expenditure of tidelands funds for the acquisition of a portion of the Harbor Center Project property, approved the expenditure based upon various conditions. One such condition was that the acquisition cost to the trust would amount to \$3.5 million. As stated previously, due to delays caused by the eminent domain litigation, actual litigation costs to the trust amounted to over \$5 million. This is over \$1.5 million in excess of what the Commission approved in 1983 and as such, is inconsistent with the Commission's approval.

Another condition was that the conveyance would occur within 180 days of the Commission's action. The conveyance of fee title of the public portion of the Harbor Center Project from the Redevelopment Agency to the City, as trustee, took place over four years beyond the extended deadline of August 27, 1986, authorized by the Commission in February 1985. As such, the City did not comply with the Commission's approval.

Additionally, the Commission's 1983 approval explicitly contemplated using trust funds for the acquisition of the public portion of the Harbor Center Project. However, while the property ultimately became a trust asset, trust funds were expended and converted into a debt, using a redevelopment law mechanism of tax increment financing. Such a financing mechanism was never considered by the Commission in approving the expenditure of trust funds by the City. However, Commission staff believes that the City's commitment to repaying the loan may serve as an element of a formal resolution between the Commission and the City regarding the Harbor Center Project.

Public Portion Lease

As stated previously, the cost of this project to the Tidelands Fund was over \$5 million and the City, as trustee, receives a fixed \$12,000 per year in rent for 50 years. This lease amount is not reflective of commercial market rates and is less than adequate as a percentage of return on investment (0.24%). While it appears that this transaction meets the City's redevelopment goals, the City did not meet its fiduciary obligations as a trustee to manage its trust assets. Furthermore, the

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parking structure is open to the public at the rate of \$18 per day but guests of the hotel get a \$5 discount. Across the street is the Plaza Parking Structure, also approved by the Commission and constructed and owned by the Tidelands Trust, which charges \$7.50/day to park. Therefore, the primary rationale for the parking structure, as presented to the Commission, which was to support parking for the general public to access the harbor, is not fully realized. Further, the Legislative tidelands grant expressly prohibits discrimination in rates by the City on trust property.

The City contends that the low rate of return received for the lease should be viewed in the context of how the City's non-trust funds have contributed to the City's tidelands operations and infrastructure. The City points out that subsequent to the series of natural disasters in 1988, which destroyed the pier and depleted the Tidelands Fund, the City used approximately \$9.6 million in non-trust funds to reconstruct the pier, a trust asset. Moreover, the City contends that it voluntarily converted the tidelands funds used to acquire the Harbor Center property into a debt to be repaid. The non-trust funds used to reconstruct the pier and the City's voluntary obligation to repay the trust is considered a gift to the trust and cannot be considered as a substitute for receiving a lower rate of return after the fact. Without a formal resolution of these matters the City's position should be rejected.

Gold's Gym

The State Lands Commission did not approve Gold's Gym as a land use in its 1983 approval. The Commission's 1983 approval was based on the finding that the use of the acquired property would be a public parking structure and open landscaped areas. While staff became aware of Gold's Gym in 2001, this was several years after Gold's Gym was constructed. Moreover, the rationale for the parking structure was in support of public access to the harbor. Gold's Gym is not an appropriate public trust use, or one necessary and incidental in support of those uses and is not authorized by the City's granting statutes or the Public Trust Doctrine.

Conclusions/Recommendations

The City, as Trustee for the state, has an obligation to insure that not only are trust assets used for uses consistent with the trust, but that the trust receives a fair rate of return on its commercial property. Staff believes that the City, because of the unanticipated increased costs of its condemnation action, entered into transactions with the hotel developer that provided a benefit to the City and its redevelopment program and contractually shortchanged the Tidelands Fund by securing a rental rate of \$12,000 per year, which is well below a fair rental rate of return for the lease of trust assets for the Harbor Center property. Staff considers this on its face to be a mismanagement of Tidelands Trust funds and assets in the City's dealings with the

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Harbor Center Project. Furthermore, the City violated certain procedural requirements of the Commission's approval of trust funds for the Harbor Center Project.

Staff's recommendations to resolve the above described issues include:

- (1) The City's promise to repay the Tidelands Fund be formalized with a payment schedule that would allow the continuing support for paying off the Pier Bond indebtedness and the payback of the Harbor Center funds, with additional requirements that the City notify the Commission staff prior to entering into any leases for periods longer than 5 years and that the City either compensate the Commission for the staff time spent on conducting this audit or provide funding for staff time spent on reviewing and monitoring future transactions involving trust lands and assets.
- (2) The Commission could seek legislation, updating and amending the City's granting statute to legitimize the existing non-trust use during the remaining lease term.

The City owns certain uplands in and adjacent to King Harbor that are being used for trust purposes and could be integrated into the trust as assets more appropriate and beneficial to the trust than the Harbor Center land. As an alternative for legitimizing the existing non-trust use, the Commission could direct staff to work with the City to exchange out the Harbor Center parcel for a more appropriate parcel of City owned lands.

Kincaid's Restaurant

Background

Kincaid's, a restaurant facility, is located on the City's "Horseshoe" portion of the Redondo Beach Pier, on legislatively granted Public Trust lands. In 1997, the City and RUI ONE Corporation (RUI) entered into an agreement for the construction of Kincaid's, in which RUI would initially finance the entire project, with an agreement that the City would reimburse RUI for 50% of the costs. The Redondo Beach Public Financing Authority (PFA), a financial branch of the Redevelopment Agency, in turn used, as collateral, future rents from Kincaid's and acquired a twenty-year bank loan for \$1.75 million, from which loan proceeds the PFA paid RUI 50% of the project costs. The construction project was completed in April 1999 and the restaurant opened in May 1999. The cost of this project was \$3.3 million.

As described above, the City's financing was arranged through the PFA. The PFA is a sinking fund and as such its primary function is a repository of monies to be held to

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pay down debt obligations as they come due. It is not an enterprise fund and therefore does not incur operating expenses. The City, as trustee, leases this property to the PFA, as tenant. The PFA then subleases the property to Kincaids. There is no guaranteed minimum rent to the Tidelands Fund, only PFA's net proceeds are transferred to the trust after payment of agreed to costs.

Despite the lack of guaranteed income to the trust, according to the City, Kincaid's has been very successful for the trust. The contractual percentage rent to the PFA is 6.5% of sales against a minimum of \$225,000 per year. However, from the percentage or minimum rent certain costs are first paid. Although these costs may change and under the lease must be paid before any pass through rent goes to the trust, a typical year expenses include:

-loan payments (principal and interest)	\$145,880/yr
-water utilities	\$ 8,000/yr
-possessory interest tax	\$ 43,600/yr
<hr/> Total average costs	<hr/> \$ 197,480/yr

This results in a typical, but not guaranteed, minimum rent of \$27,520 to the trust. Actual sales have trended between \$5.2 and \$6.0 million per year generating roughly \$350,000 to \$390,000 in annual income (less costs). As property owner of the Kincaid's Restaurant building, the PFA must pay Pier Association dues based upon the restaurant's annual sales. Kincaid's Restaurant, in turn, reimburses the PFA for the amount of the dues paid. Through June 30, 2004, Kincaid's lease with the PFA generated a total of \$1.76 million of which \$995,000 has been retained by the PFA to repay the loan and cover PFA agreed to expenses and \$776,000 has been passed through to the Tidelands Fund (\$155,200 average annual return to the trust).

Analysis

As stated previously, pursuant to the City's granting statutes, any capital expenditure of Tidelands funds in excess of \$250,000 requires CSLC approval. Staff believes that collateralization of future rents from an asset within the Tidelands Trust is tantamount to a capital expenditure under the City's granting statutes. The City, through the PFA, acquired a \$1.75 million loan to repay RUI, using future rents from Kincaid's as collateral. Arguably, this transaction should have received Commission review and approval, as trust assets would be ultimately liable for the loan. The City did not request Commission review of the subject transaction.

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Conclusion/Recommendations

The City circumvented its statutory requirement to secure CSLC approval prior to allowing the PFA to use future rents from Kincaid's as collateral for the \$1.75 million loan in order to repay RUI. As such, staff recommends:

- The City should seek retroactive approval of the expenditure of trust funds.
- The City should submit a detailed accounting of the income and expenditures of the Kincaid's lease and sublease annually, in addition to its responsibilities under PRC Section 6306.

EXHIBITS:

- A. Location and Site Map
- B. Map of Harbor Center Project

IT IS RECOMMENDED THAT:

1. THE STATE LANDS COMMISSION DIRECT STAFF TO CONTINUE TO REVIEW THE CITY'S FINANCIAL STATEMENTS AND MANAGEMENT PRACTICES TO ENSURE THE PROPER MANAGEMENT OF TIDE AND SUBMERGED LANDS GRANTED TO THE CITY OF REDONDO BEACH.
2. THE STATE LANDS COMMISSION DIRECT STAFF TO RESOLVE THE ISSUES INVOLVING THE HARBOR CENTER PROJECT AND KINCAIDS LEASE WITH THE CITY AND RETURN TO THE COMMISSION WITHIN 6 MONTHS WITH A FORMAL AGREEMENT THAT INCLUDES THE FOLLOWING ELEMENTS:
 - A. HARBOR CENTER PROJECT
 1. A REPAYMENT SCHEDULE FOR THE TIDELANDS FUNDS EXPENDED ON THE PROJECT, WITH INTEREST.
 2. COMMISSION NOTIFICATION BY THE CITY OF PROPOSED LEASES IN EXCESS OF FIVE YEARS.
 3. CITY'S AGREEMENT TO EITHER COMPENSATE THE COMMISSION FOR THE STAFF TIME SPENT ON CONDUCTING THIS FINANCIAL AUDIT OR TO PROVIDE FUNDING FOR STAFF TIME SPENT ON REVIEWING AND MONITORING FUTURE TRANSACTIONS INVOLVING TRUST LANDS AND ASSETS.
 4. LEGISLATION TO BE CO-SPONSORED BY THE CITY AMENDING THE TRUST GRANT TO THE CITY OF REDONDO BEACH AUTHORIZING THE NON-CONFORMING USE OF THE HARBOR CENTER

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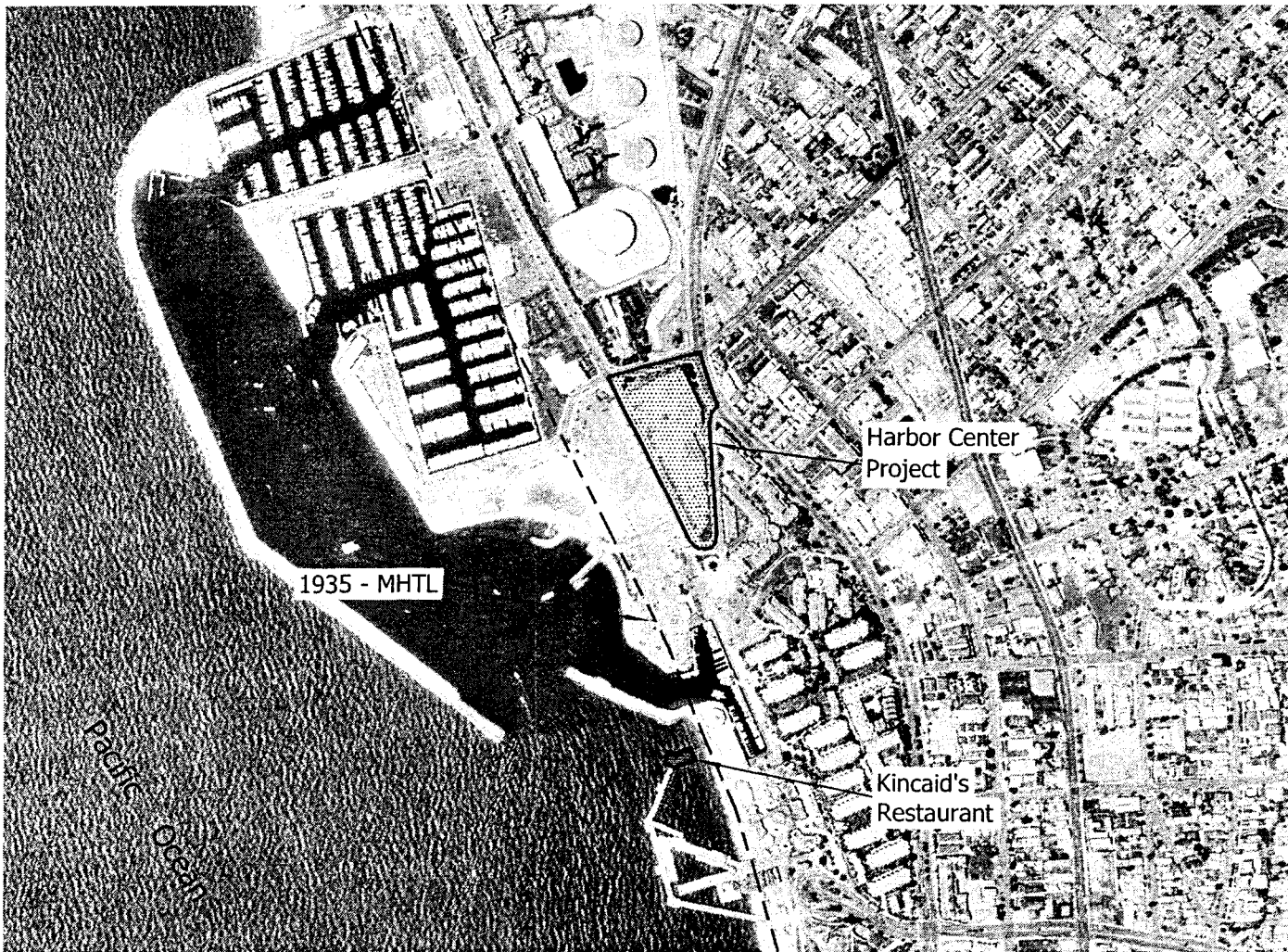
PROPERTY FOR THE EXISTING LEASE TERM OR AN EXCHANGE OF THE PROPERTY.

B. KINCAID'S

1. THE CITY'S AGREEMENT TO SUBMIT A DETAILED ACCOUNTING OF THE INCOME AND EXPENDITURES RELATING TO THE KINCAID'S LEASE AND SUBLEASES ON AN ANNUAL BASIS, IN ADDITION TO ITS RESPONSIBILITIES UNDER PRC SECTION 6306.
2. THE CITY'S AGREEMENT TO SEEK RETROACTIVE APPROVAL OF THE TRANSACTION INVOLVING THE DEDICATION OF \$1.75 MILLION OF INCOME FROM TRUST LANDS PURSUANT TO CHAPTER 1555, STATUTES OF 1971.

NO SCALE

SITE



HARBOR CENTER PROJECT and KINCAID'S RESTAURANT
LOCATED IN REDONDO BEACH

NO SCALE

LOCATION



Exhibit A

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CITY of REDONDO BEACH
FINANCIAL REVIEW
REDONDO BEACH
LOS ANGELES COUNTY



This Exhibit is solely for purposes of generally defining the lease premises, is based on unverified information provided by the Lessee or other parties and is not intended to be, nor shall it be construed as, a waiver or limitation of any State interest in the subject or any other property.

MAP SOURCE: U.S. COAST AND GEOD

RAB 06/06

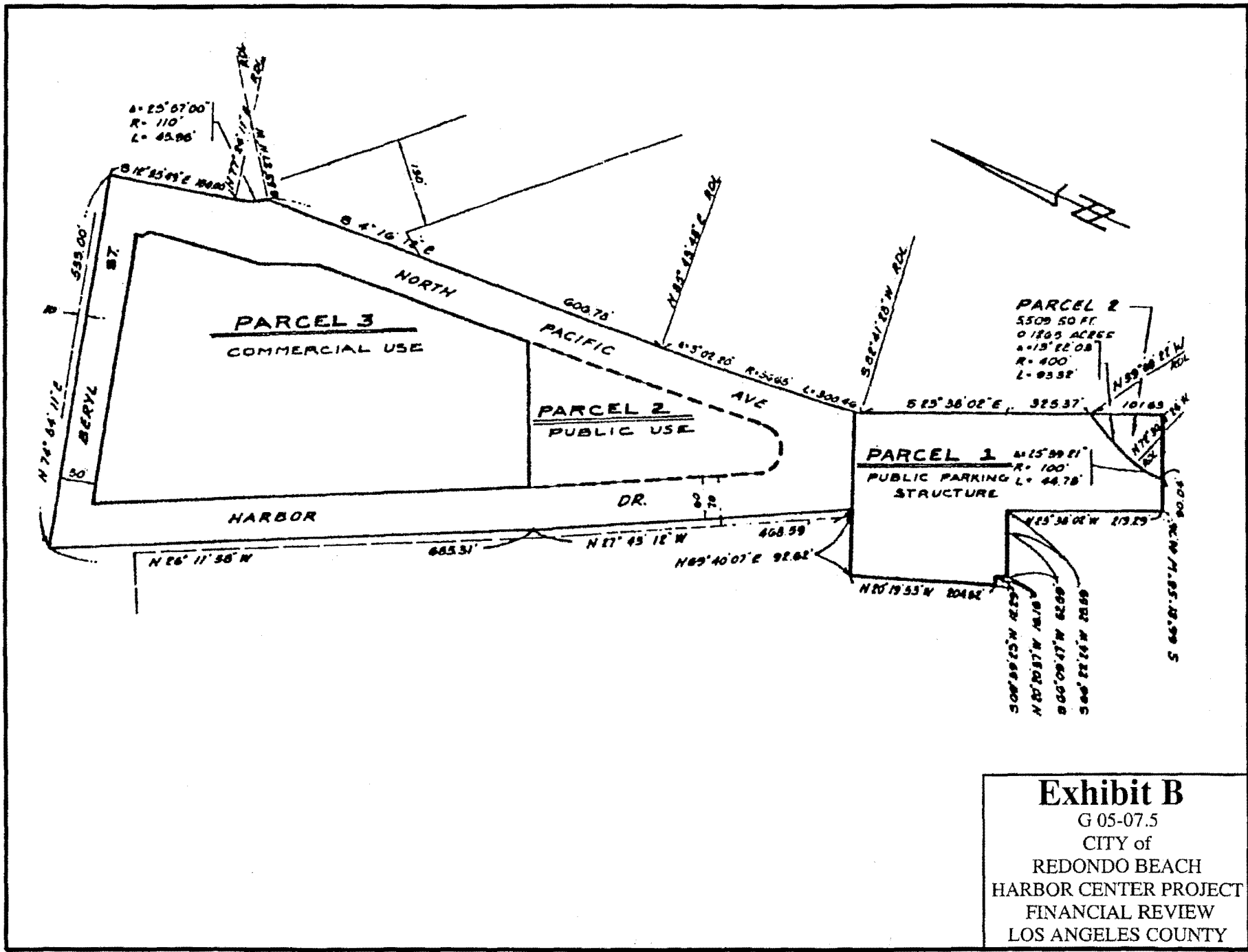


Exhibit B
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 CITY of
 REDONDO BEACH
 HARBOR CENTER PROJECT
 FINANCIAL REVIEW
 LOS ANGELES COUNTY