

Performance Audit of READ – Asset Acquisition

Fiscal Year 2021 Audit Work Plan

TITLE: Interview with Mary Lewis, former CFO for the City of San Diego

PURPOSE: To understand, from Mary's perspective, how the City came to acquire the 101 Ash Street building in a lease-to-own agreement.

DATE/TIME: 4/13/2021; 3:30 p.m.

LOCATION: MS Teams

PROGRAM PERSONNEL: Mary Lewis, former CFO, City of San Diego, Marylew@cox.net

AUDIT PERSONNEL: Andy Hanau, City Auditor
Kyle Elser, Assistant City Auditor
Megan Jaffery, Senior Performance Auditor
Carissa Nash, Performance Auditor

CONCLUSIONS: On 4/29/21 Mary Lewis verified the accuracy of the statements by email and she made some changes below in red.

SUMMARY:

Finance's Role in 101 Ash Street Transaction

- Although the Real Estate Assets Department handles real estate transactions, the Department of Finance (Finance) gets involved when financing is needed for purchase. This is not the case for straight lease transactions.
- Initially, Mary heard externally that there was a lot of discussion amongst the DCOO (e.g., Stacey LoMedico and Ron Villa) about purchasing 101 Ash Street and how the initial proposals from Sandy Shapery were too high.
- At some point,-when Cisterra became involved (she is not sure how they became involved). ~~someone suggested~~ Lakshmi and I (Finance) recommended that the City explore financing to

purchase 101 Ash outright. At that point, Mary and Lakshmi Kommi became involved. Mary directed Lakshmi to take the lead on determining the financing options and it was determined that the City could purchase 101 Ash using bonds.

- Prior to the purchase of 101 Ash, the City purchased Civic Center Plaza (CCP) using an expensive lease-to-own arrangement. At the time, the City was being sued for using bonds for **capital improvement projects/infrastructure and purchases** and did not have access to the bond market. The City has a history of being sued over its use of bonds but has always won, including winning the lawsuit shortly after the time the CCP deal was executed. For 101 Ash, Finance did not want to do another lease-to-own agreement because it was more costly than bond financing.
- The City wanted to buy 101 Ash to get employees out of decrepit City buildings **and also problematic and expensive leased space downtown** and it made sense to purchase the building because the City could buy it for \$70M-\$75M using bonds. Finance **believed** ~~felt~~ a purchase option made the most **financial** sense.
- While Finance **with the Deputy City Attorney and READ's involvement**, was lining up the purchase option, there **was momentum from Cisterra** ~~started to be some noise~~ about a lease-to-own option. There also started to be some pressure to execute the deal by a certain date or else the buyer would walk away. It was never clear to Mary what the reluctance was to buy the building directly from Shapery or Cisterra. Obviously, Cisterra stood to make more money from lease to own.
- So the plan became to buy the building through Cisterra. There were two options initially:
 1. Borrow the money through issuing bonds and then pay Cisterra for 101 Ash and reimburse them for their costs. READ took the lead on negotiations.
 2. Lease-to-own.
- Mary was very confident that City could have purchased the building with bonds (Lakshmi can verify). Municipal bonds are generally the best financing option for the City because we can get very low rates. Finance initially had a difficult time perfecting the bond contract at the time. **The bond counsel and the assigned DCA were working with Finance and READ on the contract.**

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******NOTE and Background information: A very important point that I emphasized in the interview (maybe too briefly) that should not be misstated: Bond counsel is part of the financing team but acts as an independent legal professional who provides input on the contract/deal, but is neutral to it taking place. There would be no expectation bond counsel would provide "approvals", verbal or written about the contract. They do not issue an opinion on a bond purchase until the Official Statement (OS) is published to close the bond purchase (after bonds are sold). They will, however, indicate that they see no legal impediments at the time the bonds are sold by publishing in the Preliminary Official Statement the form (unsigned) of their opinion.**

Only the OS contains the dated, written, signed legal opinion (the goal is for the opinion be unqualified) stating that the sale is a legal transaction. Therefore, the purchaser relies on the bond counsel’s opinion to buy legally issued, tax exempt bonds. Up until then, the input on the transaction coming from bond counsel to the city is only preliminary guidance on contract form and process as part of the financing team. The bond counsel may raise red flags as to areas that need work relating to the assignment language, as in this case. (Bond counsel is hired by the City Attorney’s Office.) The bond counsel does not offer any written or verbal “approval” ahead of all the legal processes, ordinances, City Council approvals, etc. being completed to issue bonds legally. This includes there not being any legal threat (lawsuit) that threaten the legality of the bonds. ~~to sign off on it (though there is no written record the approval was verbal)~~ I would not use the word “ approval”-either verbal or written approval- in describing a bond Counsel’s role. Finance was so confident they could get the bonds lined up in time they had prepared a staff report for docket with the bond option to go to Council. Since the legal process at the City for bond issuance takes weeks, Finance needed to start the approval process in September ahead of a December deadline imposed by Cisterra.

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- Eventually, a policy decision was made to purchase the building through the lease-to-own option. Although this was not the best decision in hindsight, this option was still better than maintaining the status quo – i.e., keeping employees in decrepit buildings and continuing to lease office space-based on the data provided at the time by the Real Estate Department on lease costs and market-based rent increases. Mayor’s office was under pressure to get employees out of decrepit buildings, especially the City Operations Building. Once this decision was made, Finance stepped away from the deal. ~~Finance was the only one pushing the cheaper option. (This is unknown. The COO, DCOOS, READ, and others could have been pushing for the purchase option with the Mayor. I was not aware this was happening, but it can’t be ruled out. I do believe I qualified my statements about pushing for this purchase option, since I can’t speak for everyone else.)~~

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- Mary advocated for direct purchase but also thought lease option was the second-best option based on the data provided at the time by the Real Estate Department on the status quo leasing costs in various locations. TI was projected by READ to be minimal -\$5-10M.
- Mary has not been contacted by the City’s investigators. (To clarify—I was not contacted for the City’s internal report. I have been contacted by outside investigators.)

Why the City Did Not Buy 101 Ash from Shapery/Manchester Directly

- Mary always heard second and third hand that Shapery didn’t want to sell 101 Ash to the City directly.

Cisterra’s Role

- Mary does not know how Cisterra became involved in the 101 Ash transaction.

- Cisterra's role was clear – it was a business that played the middleman between Shapery and the City to execute the purchase and sale of 101 Ash. Cisterra had a great opportunity to buy a building and lease it to the City (a government that always pays its bills and will never go out of business) and to satisfy its investors and make money.
- It doesn't make sense the sellers would not sell directly to the City. Money is money. Cisterra obviously made more money via the lease-to-own option, **and the sellers probably did too to if they preferred to lease-to-own over a direct sale.** (I don't recall saying this or maybe I was speculating since I have no idea what the deal was between the owners and Cisterra.) Cisterra would not tell the City what interest rate Cisterra was paying to borrow money for the transaction.
- Cisterra was also pressuring the City to act quickly, and said the deal had to be done by a certain date.

Jason Hughes's Role

- Jason appeared in various meetings, sometimes with Cisterra and Cybele Thompson and other times with him and the Mayor. He appeared to be the advisor to the Mayor and to act as a catalyst to making the 101 Ash deal happen. He appeared to advocate for the lease-to-own option for the City.

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Internal Controls for the Real Estate Acquisition Process

- At the time of 101 Ash, READ needed stronger financial support – they were dealing with multimillion-dollar contracts but were acting too independently and didn't have enough financial analyst support. Cybele also knew that the direct purchase for 101 Ash was the better **financial** option.
- READ needs more financial support and there needs to be more controls over **leases and** lease renewals. The CFO also needs controls on real estate deals.

Tenant Improvements (TIs)

- In the commercial world, it is common to roll TIs into lease payments.
- However, Mary did not want to roll the \$5M in TIs for 101 Ash into the lease with Cisterra; it didn't make sense to do so because the City could have either bonded the TIs at a lower interest rate or paid for them in cash reserves. Rolling them into the lease cost the City more than these other options.

READ's Role

- READ primarily negotiated deal for 101 Ash.
- READ (Cybele) provided Finance with spreadsheets (ask IBA for them) regarding the costs and projections of owning 101 Ash vs other options. Finance reviewed and relied on her assumptions and assessed their reasonableness. Finance relied on READ to be forthcoming about cost info.

City Attorney's Role

- The city attorney's office was represented by an assigned DCA who attended meetings with Cisterra and reviewed contracts with Cybele (and Finance was involved to help negotiate contract language to contain a purchase option). While it is not the city attorney's role to say whether a contract is a bad business deal, they occasionally give an opinion.