CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

**Office of the City Auditor**

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**Report to the City Council**
**City of San José**

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# AN AUDIT OF HAYES RENAISSANCE, L.P.'S COMPLIANCE WITH THE LEASE AGREEMENT FOR THE HAYES MANSION CONFERENCE CENTER

**The Hayes Renaissance, L.P. Paid The City In Accordance With The Terms Of The Hayes Mansion Conference Center (HMCC) Lease Agreement**

**The City Of San Jose Lacks Controls To Ensure That The Tenant's Deferred Percentage Rent Payments Will Be Collected When They Are Due Beginning In 2014**

**The Lease Agreement Allows The Tenant To Exclude Certain Revenues In Calculating Lease Payments Based On Gross Revenues**

**The Payment Of Half Of The Tenant's Management Fee To The HMCC's Manager Has Priority Over Lease Payments To The City And The Amount Of The Fee Is Outside The Purview Of The Lease Agreement**

**Report 02-11**
**December 2002**

# CITY OF SAN JOSÉ, CALIFORNIA

800 N. First Street • San Jose, California 95112 • Tel: (408) 277-4601

GERALD A. SILVA
City Auditor


December 13, 2002

Honorable Mayor and Members
of the City Council
801 North First Street, Room 600
San Jose, CA 95110

Transmitted herewith is a report on *An Audit Of Hayes Renaissance, L.P.'s Compliance with the Lease Agreement for the Hayes Mansion Conference Center.* This report is in accordance with City Charter Section 805. An Executive Summary is presented on the blue pages in the front of this report.

We offered the Hayes Renaissance, L.P. and the City Administration the opportunity to submit a written response for inclusion in this report. However, because both entities agree with the report findings and recommendations, they did not feel that a written response was necessary.

I will present this report to the Finance and Infrastructure Committee at its January 22, 2003, meeting. If you need additional information in the interim, please let me know. The City Auditor's staff members who participated in the preparation of this report are Mike Edmonds, Ruth Merino, and Martin Krone.

Respectfully submitted,

Gerald A. Silva

Gerald A. Silva
City Auditor

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|---|---|---|---|
| cc: | Del Borgsdorf | Kay Winer | Darrell Dearborn |
| | Peter Jensen | Nancy Johnson | Scott Johnson |
| | David Persselin | Mark Burton | Julia Cooper |
| | Mike Ryder | Rick Doyle | Danielle Keneall |
| | Jeff Davenport | Ron Havener | Carol Johnson |
| | Sara Hensley | Cay Denise Mackenzie | Ron Hunter |

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# Executive Summary

In accordance with the City Auditor's 2002-2003 Audit Workplan, we audited the Hayes Renaissance, L.P.'s compliance with the lease agreement for the Hayes Mansion Conference Center. We conducted this audit in accordance with generally accepted government auditing standards and limited our work to those areas specified in the Scope and Methodology section of this report.

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## Finding I — The Hayes Renaissance, L.P. Paid The City In Accordance With The Terms Of The Hayes Mansion Conference Center Lease Agreement

The City of San Jose (City) owns the Hayes Mansion Conference Center (HMCC) and leases it to Hayes Renaissance, L.P., a California Limited Partnership (Tenant). The Tenant makes several types of payments to the City under the Lease Agreement. We verified that the payments the Tenant made were in compliance with the terms of the Lease Agreement. Of the payments, two are calculated based on the Tenant's gross revenues. Therefore, during our audit, we reviewed the Tenant's system of internal controls at the HMCC and tested a limited number of transactions to determine whether the Tenant properly recorded all revenues.

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## Finding II — The City Of San Jose Lacks Controls To Ensure That The Tenant's Deferred Percentage Rent Payments Will Be Collected When They Are Due Beginning In 2014

In accordance with the Lease Agreement, the Tenant deferred the annual Percentage Rent payments due in 1999, 2000, and 2001. The Tenant can defer the payments and the accrued interest until 2014 and repay the deferred amounts in four equal annual installments due in each year from 2014 to 2017. However, we found that the City lacks controls to ensure that the City has accounted for and will collect these payments when they become due beginning in 2014.

**RECOMMENDATIONS**

We recommend that the Finance Department and PRNS work together to:

**Recommendation #1** **Record the 1999, 2000 and 2001 Percentage Rent deferred payments and accrued interest in the City of San Jose's Financial Management System. (Priority 2)**

## Finding III The Lease Agreement Allows The Tenant To Exclude Certain Revenues In Calculating Lease Payments Based On Gross Revenues

The HMCC charges an 18 percent service charge in connection with food and beverage services during events such as conferences, receptions, and banquets. The definition of gross revenues in the Lease Agreement allows for a deduction of revenues related to service charges which includes revenues the Tenant receives. As such, the Tenant excludes service charge revenues it receives when calculating payments to the City that are based on a percentage of gross revenues. We recommend that the City propose to the Tenant amending the Lease Agreement to explicitly include in the calculation of gross revenues for lease payment purposes, the portion of the service charges that the Tenant retains.

**RECOMMENDATIONS**

We recommend that the City:

**Recommendation #2** **Propose to the Tenant amending the Lease Agreement to explicitly include in the calculation of gross revenues for lease payment purposes, the portion of service charges that the Tenant retains. (Priority 2)**

## Finding IV The Payment Of Half Of The Tenant's Management Fee To The HMCC's Manager Has Priority Over Lease Payments To The City And The Amount Of The Fee Is Outside The Purview Of The Lease Agreement

The Tenant pays a monthly management fee to the Network Conference Company, LLC (NCC) to manage the HMCC. We found that the Lease Agreement shows that the payment of half of the management fee to NCC has priority over lease payments to the City and that the amount of the management fee is outside the purview of the City's lease. Further, the Lease Agreement neither defines nor describes the management fee. Thus, the Tenant could increase the management fee without City approval and possibly jeopardize future lease payments to the City. Further, at least two of the principals of the Tenant are also principals of NCC. We recommend that the City propose to the Tenant amending the Lease Agreement to give the City the right to approve the amount of, and any changes to, the management fee.

### RECOMMENDATIONS

We recommend that the City:

**Recommendation #3** **Propose to the Tenant amending the Lease Agreement to give the City the right to approve the amount of, and any changes to, the management fee. (Priority 2)**

# Introduction

In accordance with the City Auditor's 2002-2003 Audit Workplan, we audited the Hayes Renaissance, L.P.'s compliance with the lease agreement for the Hayes Mansion Conference Center. We conducted this audit in accordance with generally accepted government auditing standards and limited our work to those areas specified in the Scope and Methodology section of this report.

The City Auditor's Office thanks the Network Conference Company's employees, the City of San Jose's Department of Finance, the Department of Parks, Recreation and Neighborhood Services, and the Department of Conventions, Arts, and Entertainment, for their assistance with this audit.

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**Background**

The Hayes Mansion, which was originally a 64-room, 41,000 square foot mansion, is currently listed on the National Register of Historic Places and has been designated as a State and City Historic Landmark. The Hayes Mansion and the improvements are referred to in this report as the "Hayes Mansion Conference Center (HMCC)."

The City of San Jose owns the HMCC and leases it to Hayes Renaissance, L.P. (Tenant). In turn, the Tenant contracts with Network Conference Company to operate the HMCC. During the course of our review the *Second Amended and Restated Agreement to Lease By and Between City of San Jose and Hayes Renaissance, L.P.* (Second Amendment) was in effect. After our review was completed, the City and the Tenant entered into the *Third Amended and Restated Agreement to Lease By and Between City of San Jose and Hayes Renaissance, L.P.* (Third Amendment) in order to provide economic relief to the Tenant and to make changes to the auditing provisions. Unless otherwise stated in this audit, the reference to Lease Agreement means the Third Amendment, as the lease terms relevant to the audit findings are the same in both the Second and the Third Amendments. The term of the Lease Agreement runs through 2051.

Pursuant to the lease and related construction agreements, the City has issued about $64.5 million in bonds to finance the restoration and renovation of the HMCC and two expansions. Various base rent payments to the City from the Tenant fund the debt service payments on the bonds. The HMCC's operating revenues generate the rental payments.

The restoration and renovation of the HMCC began in 1993 and is referred to as Phase I. For Phase I, the City funded $11 million from a larger City bond issue and $185,000 from interest earnings on the bond proceeds. Phase I developed the Hayes Mansion into a day corporate conference center, destination restaurant, and weekend social event location.

For the first expansion, Phase II, the City issued another $22.3 million in variable rate taxable and tax-exempt bonds. The $22.3 million bond proceeds funded $15,880,000 towards construction, and the remaining $6.4 million funded capitalized interest[1], a debt service reserve fund, and bond issuance costs. The Phase II expansion included the addition of 135 guest suites, two additional meeting rooms, health club facilities, a pool, and completion of the third floor and north wing plus funding for certain improvements to Edenvale Garden Park. The Phase II improvements expanded the premises from 41,000 square feet to 118,000 square feet. The bonds for the Phase II expansion were refunded in conjunction with the issuance of variable rate bonds for Phase III.

For the second expansion, Phase III, the City issued $53.3 million in variable rate bonds. The City was also able to apply $2.5 million from the Phase II debt service reserve fund towards Phase III for a total of $55.8 million. Of this amount, approximately $22.3 was used to refund the Phase II debt, $24.4 was used to fund the Phase III construction, $1.3 million was used for Edenvale Garden Park improvements and the remaining $7.8 million funded capitalized interest, a debt service reserve fund, and bond issuance costs. Phase III, which was completed in November 2002, includes a new wing consisting of a banquet kitchen, 13,000 square feet of additional meeting space and a net addition of 79 new guest suites. The construction also includes improvements in the existing structure and a public underground parking lot in adjacent Edenvale Garden Park.

As noted above, the Lease Agreement requires the Tenant to pay the City for the debt service costs associated with

[1] The term capitalized interest means that portion of bond proceeds which are reserved to pay interest on the bonds for a specified period of time; also called funded interest. Once the period of time during which the interest payments are funded ends, then the full principal and interest payments are required.

developing and expanding the HMCC (Phases I, II, and III, with the exception of the Phase III $1.3 million park improvements which the City pays). In addition, the Tenant is required to pay the City a share of the HMCC's gross revenues. These payments are described below:

- **Phase I Base Rent** required the Tenant to pay the City graduated payments beginning in September 1994, based on a schedule in the Lease Agreement. Additionally, the City has loaned the Tenant $400,000 (which the Tenant repaid) and $4 million. Current payments for the Phase I Base Rent and the $4 million principal and interest total $101,500 per month.

- **Phase II Base Rent** required the Tenant to pay the City for the cost of the debt service for the Phase II expansion. The Tenant began making monthly payments in July 1997 according to a schedule. The Tenant was no longer required to make Phase II payments when the City used part of the Phase III bonds proceeds to refund the Phase II bonds.

- **Phase III Base Rent** requires the Tenant to pay the City for the debt service on the Phase III variable rate bonds and all annual bond expenses. In accordance with a formula specified in the Lease Agreement, the Department of Finance annually calculates the Phase III Base Rent payments. The Tenant began making Phase III Base Rent payments in February 2001. For 2002-03, the Phase III Base Rent payments are $90,145 per month.

- **Grounds Rent** requires the Tenant to pay the City an annual payment based upon a graduated schedule from 1996 through 1999 as shown in Exhibit 1. Beginning in the year 2000, Grounds Rent is $300,000 or 2% of the facility's gross revenue, whichever is greater, except for the year 2001, when it was 2% of gross revenue.

- **Percentage Rent** requires the Tenant to pay the City an annual payment of 5% of gross revenue in excess of $10,000,000 beginning in 1998. The Tenant paid the annual 1998 payment of $191,060. The Tenant can defer the payments due in 1999, 2000, and 2001 until 2014, when the Lease Agreement requires that the Tenant pay the deferred payments and accrued interest in four annual installments. For years 2002 through

2010, the percentage rents will be 6% of gross revenues for the given year in excess of $19,500,000. For each of the calendar years 2011 through 2017, the Percentage Rent shall be 10% of Gross Revenues for the given year in excess of $19,500,000. For each of the calendar years 2018 through 2051, the Percentage Rent shall be 12% of Gross Revenues for the given year in excess of $19,500,000.

Exhibit 1 below summarizes Tenant Rent Payments to the City of San Jose from 1994 to June 2002.

**Exhibit 1 Summary Of Tenant Rent Payments To The City Of San Jose From 1994 To June 2002**

| Calendar Year | Phase I Base Rent [1] | Phase II Base Rent [2] | Phase III Base Rent | Grounds Rent | Percentage Rent | Total Annual Payments |
|---|---|---|---|---|---|---|
| **1994** | $143,333 | -0- | -0- | -0- | -0- | $143,333 |
| **1995** | 530,000 | -0- | -0- | -0- | -0- | 530,000 |
| **1996** | 796,667 | -0- | -0- | $100,000 | -0- | 896,667 |
| **1997** | 942,055 | $788,106 | -0- | 125,000 | -0- | 1,855,161 |
| **1998** | 1,092,278 | 1,786,287 | -0- | 150,000 | $191,060 | 3,219,625 |
| **1999** | 1,210,658 | 1,786,287 | -0- | 200,000 | 177,309 [3] | 3,196,945 |
| **2000** | 1,218,000 | 1,794,204 | -0- | 313,005 | 282,512 [3] | 3,325,209 |
| **2001** | 1,218,000 | 156,774 | $1,094,463 | 232,505 | 81,263 [3] | 2,701,742 |
| **6/30/2002** | 609,000 | -0- | 654,922 | -0- | -0- | 1,263,922 |
| **TOTAL** | **$7,759,991** | **$6,311,658** | **$1,749,385** | **$1,120,510** | **$191,060** | **$17,132,604** |

[1] Includes payments on $4 million and $400,000 loans from the City to Tenant.
[2] The Phase II bonds were refunded in February 2001, therefore, no payments were due in 2002.
[3] Deferred until 2014 through 2017. Totals in the chart do not include these deferred payments.

As shown in Exhibit 1, Tenant has paid $17,132,604 in total rent payments to the City through June 30, 2002. The $17,132,604 shown in Exhibit 1 excludes the $541,084 in deferred Percentage Rent payments for 1999, 2000, and 2001.

The City's Department of Parks, Recreation and Neighborhood Services staff monitors and reviews the Tenant's Lease Agreement payments.

## Scope and Methodology

The objective of our audit was to determine whether the Hayes Renaissance, L.P. (Tenant) complied with the terms and conditions of the Lease Agreement.

Specifically, our audit objectives were to determine whether:

- The calculation of Grounds Rent and Percentage Rent payments for the calendar years 1999, 2000, and 2001 was accurate and

- The Tenant paid the City in accordance with the Lease Agreement in a timely manner for calendar years 1994-2002.

During the course of our audit, we:

- Reviewed the Lease Agreement and related construction agreements;

- Interviewed personnel from the City's Department of Finance, the Department of Parks, Recreation and Neighborhood Services, and the Department of Conventions, Arts, and Entertainment to determine if the Lease Agreement payments were received timely;

- Reviewed the internal controls over the accounting of gross revenues;

- Assessed the City's accounting and recording of the Tenant's payments;

- Tested the Tenant's accounting transactions at the Hayes Mansion Conference Center (HMCC);

- Reviewed the Tenant's documentation in the conference contract files that

    - authorized the event,
    - documented charges for the event, and
    - substantiated payment of the event;

- Interviewed Tenant's personnel to ascertain the accounting and recording of events that take place on and off the premises such as:

    - conferences and seminars,
    - weddings and banquets, and
    - operations of the restaurants on the premises.

We selected transactions for testing to determine whether the Tenant had adequate internal controls, sufficiently documented each transaction, and properly recorded and accounted for each transaction.

We interviewed the Tenant's Marketing Director to determine their marketing strategies, their plans to generate and attract business, and their assessment of the business environment.

We performed only limited testing of the various computer reports we used during our audit. We did not review the general and specific application controls for the computer systems used in compiling the various computer reports and databases we used.

During the course of our audit, the Tenant informed the City that cash flows had jeopardized its ability to pay its on-going operating expenses. As a result, we also reviewed provisions in the Lease Agreement regarding financial information and a management fee that could affect the Tenant's payments as discussed in Finding IV and the Other Pertinent Information section.

# Finding I The Hayes Renaissance, L.P. Paid The City In Accordance With The Terms Of The Hayes Mansion Conference Center Lease Agreement

The City of San Jose (City) owns the Hayes Mansion Conference Center (HMCC) and leases it to Hayes Renaissance, L.P., a California Limited Partnership (Tenant). The Tenant makes several types of payments to the City under the Lease Agreement. We verified that the payments the Tenant made were in compliance with the terms of the Lease Agreement. Of the payments, two are calculated based on the Tenant's gross revenues. Therefore, during our audit, we reviewed the Tenant's system of internal controls at the HMCC and tested a limited number of transactions to determine whether the Tenant properly recorded all revenues.

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**The Hayes Renaissance, L.P. Paid The City In Accordance With The Terms Of The Hayes Mansion Conference Center Lease Agreement**

As noted on pages 3 and 4 of this report, the Lease Agreement requires the Tenant to pay the City for the debt service costs associated with developing and expanding the HMCC. In addition, the Tenant is required to pay the City a percentage of the gross revenues from the operations of the HMCC. The various rent payments, which are described on pages 3 and 4, are listed below:

- Phase I Base Rent
- Phase II Base Rent
- Phase III Base Rent
- Grounds Rent
- Percentage Rent

We verified that the payments the Tenant made to the City were in compliance with the terms of the Lease Agreement. Specifically, we found that the Tenant paid the correct rent amounts and in a timely manner. As noted on pages 2 and 3, the Grounds Rent and the Percentage Rent payments are based on the Tenant's gross revenues. Therefore, during our review, we also performed tests to determine the accuracy and reliability of the Tenant's reported gross revenues. Specifically, we reviewed the Tenant's system of internal controls and tested a limited number of transactions to determine if the Tenant had accurately recorded all revenues.

We found that the Tenant's system of internal controls was satisfactory. In addition, we traced a limited number of transactions through the Tenant's accounting system from inception to the Tenant's bank deposit statements. We determined that the Tenant accurately recorded the transactions we tested.

**CONCLUSION**

We found that the Tenant paid the City in accordance with the terms of the Lease Agreement. Specifically, we found that the Tenant paid the correct rent amounts and in a timely manner.

# Finding II The City Of San Jose Lacks Controls To Ensure That The Tenant's Deferred Percentage Rent Payments Will Be Collected When They Are Due Beginning In 2014

In accordance with the Lease Agreement, the Tenant deferred the annual Percentage Rent payments due in 1999, 2000, and 2001. The Tenant can defer the payments and the accrued interest until 2014 and repay the deferred amounts in four equal annual installments due in each year from 2014 to 2017. However, we found that the City lacks controls to ensure that the City has accounted for and will collect these payments when they become due beginning in 2014.

**The City Lacks Controls To Ensure That Deferred Rents Will Be Collected**

The Lease Agreement requires the Tenant to pay a Percentage Rent which has been 5 percent of Gross Revenues. In 1998, the Tenant paid the Percentage Rent of $191,060. However, as provided in the Lease Agreement, the Tenant deferred $541,083 in Percentage Rent payments due for calendar years 1999, 2000, and 2001. Specifically, in calendar years 1999, 2000, and 2001, the Tenant deferred Percentage Rent payments of $177,308; $282,512; and $81,263; respectively.

The Lease Agreement also specifies that the deferred payments accrue simple interest at 5.5 percent per year until 2017. In addition, the Lease Agreement provides that the amount of Percentage Rent deferred, together with interest accrued until June 15, 2017 will be due in four equal installments on June 15 of 2014, 2015, 2016, and 2017.

The Lease Agreement allows the Tenant to prepay the principal and interest with no prepayment penalties. However, if the Tenant defers the principal and accumulated interest until 2014, we estimate that the total amount owed will be $1,036,054. Thus, we estimate that each of the four annual payments would be $259,014.

Exhibit 2 below shows the amount of the deferred payments, the estimated interest that would accrue, and the total amount of the payments and interest that would be due in 2017.

**Exhibit 2 Deferred Percentage Payments And Accrued Interest On Percentage Rent For The Calendar Years 1999, 2000, And 2001**

| Calendar Year Deferred | Deferred Percentage Rent Payments | Estimated Accrued Interest Through June 15, 2017 | Total Deferred Payments and Accrued Interest Through June 15, 2017 |
|---|---|---|---|
| 1999 | $ 177,308 | $ 170,219 | $ 347,527 |
| 2000 | 282,512 | 255,677 | 538,189 |
| 2001 | 81,263 | 69,075 | 150,338 |
| Total | $ 541,083 | $ 494,971 | $1,036,054 |

During our review of Percentage Rent payments, we determined that the City has not recorded the deferred payments for the years 1999, 2000, and 2001. We met with staff from the City's Finance Department and the Department of Parks, Recreation and Neighborhood Services (PRNS) regarding the deferred Percentage Rent and accrued interest payments. According to a staff member from the PRNS, she placed a note in the HMCC file regarding the deferred payments. A Finance Department staff member stated that the deferred payments have not been recorded in the City's accounting system. He added the City should record the deferred payments in the City's Financial Management System (FMS) to ensure a proper accounting of the payments.

Without recording the deferred Percentage Rent and accrued interest, the City could lose track of the $1,036,054 in deferred payments.

We recommend that the Finance Department and PRNS work together to:

**Recommendation #1**

**Record the 1999, 2000 and 2001 Percentage Rent deferred payments and accrued interest in the City of San Jose's Financial Management System. (Priority 2)**

## CONCLUSION

The Lease Agreement allowed the Tenant to defer $541,083 in Percentage Rent payments until 2014. The principal and accrued interest payments will total over $1 million if deferred to the maximum term. However, we found that the City needs to record the deferred payments in order to ensure that these payments will be collected when they are due beginning in 2014.

## RECOMMENDATIONS

We recommend that the Finance Department and PRNS work together to:

**Recommendation #1** **Record the 1999, 2000 and 2001 Percentage Rent deferred payments and accrued interest in the City of San Jose's Financial Management System. (Priority 2)**

# Finding III The Lease Agreement Allows The Tenant To Exclude Certain Revenues In Calculating Lease Payments Based On Gross Revenues

The HMCC charges an 18 percent service charge in connection with food and beverage services during events such as conferences, receptions, and banquets. The definition of gross revenues in the Lease Agreement allows for a deduction of revenues related to service charges which includes revenues the Tenant receives. As such, the Tenant excludes service charge revenues it receives when calculating payments to the City that are based on a percentage of gross revenues. We recommend that the City propose to the Tenant amending the Lease Agreement to explicitly include in the calculation of gross revenues for lease payment purposes, the portion of the service charges that the Tenant retains.

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**The Lease Agreement Allows The Tenant To Exclude Certain Revenues In Calculating Lease Payments Based On Gross Revenues**

Of the rent payments to the City, Grounds Rent and Percentage Rent are based on gross revenues as defined in the Lease Agreement. The Lease Agreement defines gross revenues as "All revenues actually received in connection with any activity or event held at the [HMCC]. Gross revenues does not include sales and use tax, transient occupancy tax or similar tax, and gratuities and service charges for food and beverage consistent with industry standards (but not exceeding 18%)…"[2]

The rationale for excluding service charges from gross revenues is that the service charges are paid to the Tenant's employees. However, the Tenant also retains a portion of the service charges. Yet, the Lease Agreement's definition of gross revenues does not distinguish between service charge income the employees receive and the service charge revenues the Tenant retains. Thus, per the Lease Agreement, the Tenant is allowed to exclude for lease payment calculation purposes the service charges it retains.

On the other hand, the Hayes Mansion Management Agreement between the Tenant and the Network Conference Center (discussed on page 1 and in Finding IV) treats service charges

[2] During the audit we tested transactions to ensure that service charges did not exceed 18%. We verified that, in fact, they did not exceed 18%.

differently. Specifically, this agreement, which prescribes how to calculate the Network Conference Center's management fee, defines gross revenues to include those service charge revenues the Tenant retains in its definition of gross revenues.

We estimate that the City would have received an additional $91,036 over the past three years had the Tenant's retained service charges been included in gross revenues for lease payment calculation purposes. Therefore, we recommend that the City propose to the Tenant amending the Lease Agreement to explicitly include in the calculation of gross revenues for lease payment purposes, the portion of service charges that the Tenant retains.

We recommend that the City:

**Recommendation #2**

**Propose to the Tenant amending the Lease Agreement to explicitly include in the calculation of gross revenues for lease payment purposes, the portion of service charges that the Tenant retains. (Priority 2)**

## CONCLUSION

We found that the Lease Agreement allows the Tenant to exclude in the calculation of gross revenues for lease payment purposes, the portion of service charges that the Tenant retains. We estimate that the City would have received an additional $91,036 over the past three years if the Tenant's retained portion of service charges had been included in gross revenues for lease calculation purposes.

## RECOMMENDATIONS

We recommend that the City:

**Recommendation #2**

**Propose to the Tenant amending the Lease Agreement to explicitly include in the calculation of gross revenues for lease payment purposes, the portion of service charges that the Tenant retains. (Priority 2)**

## Finding IV The Payment Of Half Of The Tenant's Management Fee To The HMCC's Manager Has Priority Over Lease Payments To The City And The Amount Of The Fee Is Outside The Purview Of The Lease Agreement

The Tenant pays a monthly management fee to the Network Conference Company, LLC (NCC) to manage the HMCC. We found that the Lease Agreement shows that the payment of half of the management fee to NCC has priority over lease payments to the City and that the amount of the management fee is outside the purview of the City's lease. Further, the Lease Agreement neither defines nor describes the management fee. Thus, the Tenant could increase the management fee without City approval and possibly jeopardize future lease payments to the City. Further, at least two of the principals of the Tenant are also principals of NCC. We recommend that the City propose to the Tenant amending the Lease Agreement to give the City the right to approve the amount of, and any changes to, the management fee.

As part of our audit, we reviewed the *Hayes Mansion Conference Center Management Agreement* between the Tenant and Renaissance Conference Company, Inc. dated March 15, 1993 (Management Agreement). According to the NCC's Chief Financial Officer, the Renaissance Conference Company, Inc. legally changed its name to the Network Conference Company, LLC. According to the Management Agreement, the Tenant will pay the manager (currently NCC), as compensation for its services, a management fee of seven percent of all gross revenues received from the HMCC during the term of the Management Agreement. The Management Agreement also states that "If, for any month, the Lease requires that the Management Fee not be paid, such Fee shall continue to accrue together with interest thereon at Prime Rate, and such Fee and interest shall be payable as soon as permitted under the provisions of the Lease." According to the September 2002 consultant report, *Market Study, Operational Review, and Cash Flow Analysis*, regarding the HMCC, the management fee for 2000 and 2001 was $812,000 and $601,000, respectively.

The NCC's Chief Financial Officer stated that the City was aware of the terms of the management fee when the Management Agreement was executed. However, the Lease Agreement neither defines nor describes the management fee. Therefore, the Tenant can change the management fee without City approval. In fact, the Tenant and NCC have changed the management fee. However, it should be noted that the change to the management fee did not adversely affect the City. In 1997, the Tenant and NCC revised the Management Agreement and reduced the management fee from 7 percent to 5 percent.

A provision of the Lease Agreement lists the allocation of revenues in priority order. The top priority of the allocation of revenues is all operating expenses including half of the management fee. Therefore, the Lease Agreement allows for half of the management fee to be paid prior to any of the lease payments to the City. The priority order for the remaining half of the management fee is after the Tenant makes lease payments to the City. Thus, if the Tenant increased the monthly management fee, the lease payments to the City could be affected. In addition, the President and Secretary of Hayes Renaissance, Inc., who executed the Management Agreement for the General Partner on behalf of the Tenant, also signed as President and Secretary of the Renaissance Conference Company, which later changed its name to NCC. In our opinion, the City should propose to the Tenant amending the Lease Agreement to give the City the right to approve the amount of, and any changes to, the management fee.

We recommend that the City:

**Recommendation #3**

**Propose to the Tenant amending the Lease Agreement to give the City the right to approve the amount of, and any changes to, the management fee. (Priority 2)**

## CONCLUSION

The Tenant pays a monthly management fee to the HMCC's manager. We found that the Lease Agreement does not define or describe this management fee. Also, payment to NCC of half of the management fee has priority over lease payments to the City, and the amount of the fee is outside the purview of the City. We recommend that the City propose to the Tenant amending the Lease Agreement to give the City the right to approve the amount of, and any changes to, the management fee.

## RECOMMENDATIONS

We recommend that the City:

**Recommendation #3** **Propose to the Tenant amending the Lease Agreement to give the City the right to approve the amount of, and any changes to, the management fee. (Priority 2)**

# Other Pertinent Information

The City of San Jose (City) has invested over $64 million in the Hayes Mansion Conference Center (HMCC) and leases it to Hayes Renaissance, L.P., a California Limited Partnership (Tenant). Because two of the various types of the Tenant's payments to the City were based solely on gross revenues, the Second Amendment required the Tenant to maintain and have available for City audit only the financial information that is related to gross revenues. It did not require the Tenant to provide financial statements or other information to facilitate monitoring the financial position of the HMCC. In conjunction with the financial assistance package for the Tenant that the City Council approved in September 2002, the City and the Tenant entered into the Third Amendment to require the Tenant to provide the following monthly and annual financial statements regarding the HMCC:

1. A balance sheet as of the end of each month;

2. The related statements of operations and changes in equity;

3. Statements of cash flows for such month; and

4. Provide in comparative form for requirements 1, 2, and 3 above, the figures for the same month in the previous fiscal year and year-to-date.

In addition, the Tenant shall also furnish year-end audited financial statements. By amending the Lease Agreement to require monthly and annual financial statements the City will be better able to monitor the financial position of the Tenant regarding the HMCC.

## APPENDIX A

## DEFINITIONS OF PRIORITY 1, 2, AND 3 AUDIT RECOMMENDATIONS

The City of San Jose's City Administration Manual (CAM) defines the classification scheme applicable to audit recommendations and the appropriate corrective actions as follows:

| Priority Class[1] | Description | Implementation Category | Implementation Action[3] |
|---|---|---|---|
| 1 | Fraud or serious violations are being committed, significant fiscal or equivalent non-fiscal losses are occurring.[2] | Priority | Immediate |
| 2 | A potential for incurring significant fiscal or equivalent fiscal or equivalent non-fiscal losses exists.[2] | Priority | Within 60 days |
| 3 | Operation or administrative process will be improved. | General | 60 days to one year |

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1 The City Auditor is responsible for assigning audit recommendation priority class numbers. A recommendation which clearly fits the description for more than one priority class shall be assigned the higher number. **(CAM 196.4)**

2 For an audit recommendation to be considered related to a significant fiscal loss, it will usually be necessary for an actual loss of $25,000 or more to be involved or for a potential loss (including unrealized revenue increases) of $50,000 to be involved. Equivalent non-fiscal losses would include, but not be limited to, omission or commission of acts by or on behalf of the City which would be likely to expose the City to adverse criticism in the eyes of its citizens.
**(CAM 196.4)**

3 The implementation time frame indicated for each priority class is intended as a guideline for establishing implementation target dates. While prioritizing recommendations is the responsibility of the City Auditor, determining implementation dates is the responsibility of the City Administration.
**(CAM 196.4)**