City of Miami

THEODORE P. GUBA, CPA, CIA, CFE
INDEPENDENT AUDITOR GENERAL

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August 7, 2014

Honorable Members of the City Commission
City of Miami
3500 Pan American Drive
Coconut Grove, FL 33133-5504

Re: Audit of Bayside Marketplace for the period October 1, 2010 through December 31, 2012
Audit No. 14-008

Executive Summary

We have completed an audit of records and selected financial transactions of General Growth Properties, Inc. (GGP—formerly the Rouse Company), primarily for the period October 1, 2010 through December 31, 2012. The audit was performed to determine whether GGP, in its development and operation of Bayside Marketplace (Bayside), which was constructed on the City of Miami's (City) Bayfront Park site, complied with the applicable sections of its Lease and Development Agreement (Lease) with the City. The lease expires in 2030 and can be extended for two additional 15 year periods. During fiscal year 2011 (FY 2011) and FY 2012, GGP made minimum rent payments as stipulated in the Lease totaling $2,021,010 (including $2,000,000 for the retail parcel/shopping center and $21,010 for the garage).

Overall, we have concluded that except for what we believe is an inaccurate calculation of Net Income Available for Distribution (NIAD), which is disputed by GGP, GGP has complied with the terms of the lease. This NIAD calculation is used to determine whether the City will receive "Participation Rent" above minimum rent payments. However, regardless of the NIAD calculation used to determine "Participation Rent", the City will continue to receive only a minimum annual rental payment of $1,010,000 for the foreseeable future.

It should be noted that pursuant to the approval of an amended Lease at the June 26, 2014 Commission meeting, which is subject to voter referendum approval on August 26, 2014, the NIAD provisions will be eliminated and replaced with the following rental income provisions: an annual minimum rent of $2.2 million plus annual CPI increases capped at 3%; percentage rent of 6% and 15% of gross revenue over natural break-points for the retail parcel/shopping center and the garage respectively (NOTE: the natural break-point is equal to the annual minimum rent divided by 6% or 15%); an additional $241,920 per year commencing on the opening date of the garage expansion; a $10 million lump-sum payment; a 3% participation in the first $125 million of future re-financing; an annual $1.059 million payment and 1% of gross revenues over a $55 million breakpoint, plus 6% of gross revenues from the Sky Rise Miami Tower (Tower) valet service once the Tower is completed; and, an increase of the minimum payment of the foundation contribution in the Minority Participation Agreement from $100,000 to $350,000 per year. Details of our findings are included on pages 3 through 5 of the report.

We wish to express our appreciation for the cooperation and courtesies extended to us by the GGP's management and accounting staff while conducting the audit.

Sincerely,

Theodore P. Guba

Theodore P. Guba, CPA, CIA, CFE
Independent Auditor General
Office of the Independent Auditor General

cc: The Honorable Mayor Tomas Regalado
Daniel Alfonso, City Manager
Victoria Mendez, City Attorney
Todd Hannon, City Clerk
Alice Bravo, Deputy City Manager/Chief of Infrastructure
Fernando Casamayor, Assistant City Manager/Chief Financial Officer
Nzeribe Ihekwaba, Assistant City Manager/Chief of Operations
Christopher Rose, Director, Office of Management and Budget
Jose Fernandez, Director, Finance Department
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Aldo Bustamante, Assistant Director, Public Facilities Department
John Charters, General Growth Properties, Inc.
Patricia Campanile, General Growth Properties, Inc.
Majorie Zessar, General Growth Properties, Inc.
Elizabeth James, General Growth Properties, Inc.
Lucia Dougherty, Greenberg Traurig, LLP
Members of the Audit Advisory Committee
Audit Documentation File

Audit conducted by: Lewis Blake, CPA, CIA, Audit Manager

Audit reviewed by: Marcus Cabral, CPA, CISA, Senior Auditor

AUDIT OF BAYSIDE MARKETPLACE
OCTOBER 1, 2010 THROUGH DECEMBER 31, 2012

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SCOPE, OBJECTIVES AND METHODOLOGY

The scope of the audit was to determine General Growth Properties, Inc. (GGP's) compliance with rental payment, insurance, and maintenance provisions of its Lease and Development Agreement (Lease) with the City of Miami (City). The audit primarily covered the period October 1, 2010 through December 31, 2012 and focused on the following objectives:

- To determine whether GGP complied with the terms of the Lease to the extent that GGP rent payments to the City were consistent with gross revenues that were reported to the City; and, that such gross revenues were consistent with State of Florida sales and use tax returns, federal tax returns and, bank deposits.
- To determine whether GGP rent payments were remitted in a timely manner.
- To determine whether insurance policies were adequate and in compliance with rental agreement terms.
- To determine whether rent payments were properly recorded in the City's accounting system and deposited into the City's treasury.
- Other audit procedures as deemed necessary.

We conducted this audit in accordance with *Generally Accepted Government Auditing Standards*. Those standards require that we plan and perform the audit to obtain sufficient and appropriate evidence in order 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. The audit methodology included the following:

- Interviews and inquiries of appropriate personnel
- Reviews of written policies and procedures in order to gain an understanding of the internal controls
- Observations of current practices and processing techniques
- Tests of applicable transactions and records
- Other audit procedures as deemed necessary

BACKGROUND

The City of Miami (City) owns a waterfront site known as Bayfront Park, which includes the 17 acre Bayside Marketplace shopping center (Bayside). Subsequent to issuing a request for proposal (RFP) to develop and lease the retail specialty center, the City executed a Lease and Development Agreement (Lease) with General Growth Properties (GGP—formerly the Rouse Company), dated October 17, 1985. Bayside, which opened in 1987, contains 231,000 square feet of leasable retail space.

The Lease has an initial term of 45 years which expires in 2030 and can be extended for two (2) additional 15 year periods resulting in an expiration date of 2060. The Lease for the retail space at Bayside provides for minimum annual rent payments of $1 million and the parking garage lease provides for minimum annual rent of $10,000.

The following summarizes key components of the retail space Lease:

Participation Rent: In addition to receiving the $1,000,000 minimum annual rent, the Lease allows the City to "participate" in, or receive, some of the profits generated from the retail space. As such, GGP must pay the City the greater of $1 million **or** 35% of the retail space's Net Income Available for Distribution (NIAD), which must be calculated quarterly and is defined as follows:

1. Operating Income (i.e. "Total Revenue") "for the applicable or pertinent period…"
2. Less: Operating Expenses "for the same period…"
3. Less: Debt Service Payments "for the same period…"
4. Less: 10% of Developer's Equity Investment (DEI) "for the same period…"
   DEI is defined and calculated as follows:
   a. Development Cost – The cost of the "initial development and construction…" of Bayside
   b. Plus: Un-recouped/Unfinanced cost of improvements subsequent to initial development and construction.
   c. Plus: Operating Loss – "…the amount by which Operating Income for the applicable period is less than the aggregate of Operating Expenses…plus Debt Service Payments for the same period."
   d. Less: Net Proceeds "actually received…from any and all Leasehold Mortgages…"

Cumulative Credit Balance Account: The Lease provides that, in years when 35% of NIAD is less than the $1 million minimum annual rent, the difference is credited to GGP in a Cumulative Credit Balance Account (the "CCBA"), which accrues interest at 11%. The unaudited CCBA, which was $43 million as of 2012, is applied against future payments of Participation Rent. Consequently, even if our 2012 calculation of the NIAD (35% of NIAD) was considered (at $2,729,335), the City will not receive Participation Rent for the foreseeable future since the balance will be reduced by only $1,729,335 ($2,729,335 - $1 million minimum annual rent).

AUDIT FINDINGS AND RECOMMENDATIONS

CONCLUSION: Overall, GGP has complied with the lease terms. Specifically, reported gross revenues were consistent with tax returns and bank deposits; rent payments were remitted timely and properly recorded, and insurance policies were in compliance with lease requirements. It should be noted that, based on our review of lease provisions regarding the calculation of DEI, which is a major component of NIAD (which is used to determine if the City will receive "Participation Rent" above the "Minimum Rent"), GGP used operating losses from 1987 through 1992, which we believe was contrary to the terms of the lease. In addition, GGP did not include net proceeds from "…any and all leasehold mortgages…" in its DEI calculation, However, regardless of the NIAD used, and due to the large balance in the CCBA, the City will continue to receive only minimum rent payments for the foreseeable future.

It should be noted that, pursuant to the approval of an amended Lease at the June 26, 2014 Commission meeting, which is subject to voter referendum approval on August 26, 2014, the NIAD provisions will be eliminated and replaced with the following rental income provisions: an annual minimum rent of $2.2 million plus annual CPI increases capped at 3%; percentage rent of 6% and 15% of gross revenue over natural break-points for the retail parcel/shopping center and the garage respectively (NOTE: the natural break-point is equal to the annual minimum rent divided by 6% or 15%); an additional $241,920 per year commencing on the opening date of the garage expansion; a $10 million lump-sum payment; a 3% participation in the first $125 million of future re-financing; an annual $1.059 million payment and 1% of gross revenues over a $55 million breakpoint, plus 6% of gross revenues from the Sky Rise Miami Tower (Tower) valet service once the Tower is completed; and, an increase of the minimum payment of the foundation contribution in the Minority Participation Agreement from $100,000 to $350,000 per year.

FINDING 1: CALCULATION OF NET INCOME AVAILABLE FOR DISTRIBUTION IS INACCURATE

In order to derive NIAD, operating expenses, debt service payments, and DEI are deducted from GGPs "Total Revenue"; and, 35% of NIAD (See **Schedule I** on page 5) is compared to the $1 million minimum base rent. The 35% of NIAD amounts that exceed the $1 million reduce the "Total Balance" in the Cumulative Credit Balance Account (CCBA); which GGP has calculated to be $43 million. The CCBA will eventually be "reduced to zero" as Bayside becomes more profitable and the NIAD increases. At that point, the City will be able to commence receiving "Participation Rent" in excess of the $1 million minimum base rent. However, due to the CCBA's large balance and the accrual of interest at 11% per year, the City will receive only the minimum rent for the foreseeable future.

We noted that pursuant to lease requirements, GGP submitted an initial "35% of NIAD" calculation of $1.88 million for 2012 which differed from our calculation of $2.73 million by $847,640. After questioning its calculation, GGP proffered a revised calculation which significantly decreased the NIAD calculation to $0.00, or a $2.73 million difference from our calculation **(Items 6a and 7)**. In effect, GGP calculated a year-to-date DEI (DEI is defined as: "Development Costs", plus "Un-Recouped/Unfinanced cost of Capital Improvements" made to the project after initial construction, plus "Operating Loss" for the period, less "Net proceeds" received from Leasehold Mortgages. **[Schedule I, Items 4 through 4d]**), which included no net borrowings or "Net proceeds of Leasehold mortgage (**Item# 4d**). In addition, in its calculation of DEI, GGP used cumulative totals ($15.68 million) of Bayside operating losses from 1987 through 1992 (**Item# 4c**), which we believe is contrary to the terms of the lease.

Including cumulative operating losses and excluding net borrowings from the DEI calculation drastically increases DEI, significantly reduces NIAD, and does not reduce the total CCBA balance which is contrary to the apparent intent of the lease which requires a DEI calculation that facilitates a return on GGP's <u>initial</u> equity investment while also factoring in <u>period</u> (not cumulative) operating losses (if any). Also, the lease agreement alluded to the <u>increase of NIAD</u> and the City's eventual participation in GGP's profits as Bayside becomes more profitable. However, GGP's methodology for calculating NIAD diminishes the possibility of ever eliminating the credit balance in the CCBA so that the City can participate in Bayside's profitability.

<u>RECOMMENDATION</u>:

In the event that the referendum fails, the City should revisit this issue and consider its options.

- **<u>GGP Response</u>***:* GGP disagreed with the finding (See Attached Letter Dated February 27, 2014 on Pages 6 through 9)

SCHEDULE I

BAYSIDE MARKETPLACE
COMPARISON OF NET INCOME AVAILABLE FOR DISTRIBUTION CALCULATION
FOR THE YEAR ENDED 2012

Item#	NIAD Components	OIAG's NIAD Calculation	GGP's Revised NIAD Calculation
		2012	2012
1	**Total Revenues (Operating Income per lease language)**	**$ 23,539,095**	**$ 23,539,095**
2	**(Less): Operating expenses**	**8,906,281**	**8,906,281**
3	**(Less): Debt service payments**	**3,914,278**	**3,914,278**
	Net Operating Income	**10,718,536**	**10,718,536**
4	**Developer's Equity Investment:**		
4a	Development Cost	68,536,467	68,536,467
4b	**(Plus):** Unrecouped/Unfinanced cost of capital improvements after initial construction	27,307,892	27,307,892
4c	**(Plus):** Operating loss	-	15,677,651
4d	**(Less):** Net Proceeds Leasehold Mortgage ($68M less 2% closing costs)	(66,640,000)	-
5	**Total Developer's Equity Investment**	**29,204,359**	**111,522,010**
5a	**(Less): 10% of Total Developer's Equity Investment**	**2,920,436**	**11,152,201**
6	**Net Income Available for distribution (NIAD)**	**7,798,100**	**-**
6a	**35% of NIAD**	**2,729,335**	**-**
7	**Difference between OIAG calculation and GGP' calculation**	**$2,729,335**	

GGP's RESPONSE TO FINDING

GGP

February 27, 2014

VIA EMAIL AND FEDERAL EXPRESS

Mr. Enrique (Henry) Torre
Director
City of Miami
Public Facilities Division /Asset Management Division
444 SW 2nd Avenue, 3rd Floor
Miami, FL 33130

Re: That certain Amended and Restated Lease Agreement dated October 15, 1985 (as amended, collectively, the "Retail Ground Lease"), between the City of Miami, as landlord (the "City"), and Bayside Marketplace, LLC, a Delaware limited liability company ("Developer"), successor-by-merger to Bayside Center Limited Partnership, as tenant

Dear Mr. Torre:

Reference is hereby made to the Legal Services Request dated January 7, 201[4] from Theodore Guba of the Office of the Independent Auditor General to the Office of the City Attorney (the "LSR"). As discussed on our February 12th conference call, this letter shall serve as Developer's response to the two issues raised in the LSR pertaining to certain underlying components of the Developer Equity Investment ("DEI") calculation, which calculation is a key component of Net Income Available for Distribution ("NIAD"), as described below. It's critical for the City to keep in mind that the intention of the rental structure under both the Retail Ground Lease (and the Parking Garage Ground Lease) and the deduction of 10% of DEI from the NIAD calculation was to enable Developer to earn a return on its equity investment in Bayside Marketplace (assuming there is sufficient cash flow) before the City shares in the net amount; it being agreed that the City would receive the guaranteed Minimum Base Rental. This concept was highlighted in the letter dated June 11, 2001 from Developer to the City of Miami Department of Internal Audits and Review and referenced in the LSR.

Pursuant to the Retail Ground Lease, the term "Net Income Available for Distribution" is defined as follows:

> "Net Income Available for Distribution" means the Operating Income for the applicable or pertinent period, minus the sum of (1) Operating Expenses for the same period, (2) Debt Service Payments for the same period, and (3) an amount equal to ten percent (10%) of the Developer's Equity Investment for the same period.

General Growth Properties, Inc. | 110 North Wacker Drive | Chicago, Illinois 60606 | 312-960-5000 | www.ggp.com

Further, the term "Developer Equity Investment" is defined in the Retail Ground Lease as follows:

> "Developer Equity Investment" means the sum of (i) Development Cost, (ii) an amount equal from time to time to any unrecouped and unfinanced cost of Capital Improvements made and paid for by Developer after initial construction of the Developer Improvements, and (iii) Operating Losses (excluding Rentals other than Additional Rental) less (iv) the net proceeds actually received by Developer from any and all Leasehold Mortgages or all Sale-Subleaseback Transactions of Developer's estate in the Leased Property and Improvements.

The issues raised in the LSR pertain only to clauses (iii) and (iv) of the definition of Developer Equity Investment. We have addressed each clause individually below. Please note that all capitalized terms not otherwise defined in this letter shall have the meanings set forth in the Retail Ground Lease.

OPERATING LOSSES

As noted in the LSR, Developer includes the cumulative Operating Losses incurred from 1987 through 1992 in the amount of $15,677,651 in its calculation of Developer Equity Investment under the Retail Ground Lease. The City's auditor is asserting that Developer's inclusion of cumulative Operating Losses is "contrary to the terms of the lease" because it serves to increase DEI and reduce NIAD. Also, as raised on the conference call, the City's auditor claims that Developer's inclusion of cumulative Operating Losses in the DEI calculation is contrary to the definition of "Operating Losses" in the Retail Ground Lease which refers to a specific period in time.

Developer respectfully disagrees with the interpretation of the Retail Ground Lease by the City's auditor. As mentioned above, the purpose of the DEI component of the NIAD calculation is for Developer to receive a return on its equity investment, which equity investment changes over time and includes a number of components. If the DEI calculation were intended, as the City's auditor asserts, to facilitate a return only on Developer's initial equity investment, then why would the DEI calculation include clause (ii) – unrecouped and unfinanced cost of Capital Improvements made and paid for by Developer after the initial construction of the Developer Improvements? The Operating Losses incurred by Developer from 1987 through 1992 are akin to an additional equity investment by Developer that has not been recouped. The fact that clause (iii) of the DEI definition does not include the word "cumulative" doesn't obviate the fundamental purpose of this provision. Moreover, while other computations (such as NIAD) are expressly tied to particular periods of time, the DEI calculation is not (thereby implying that Operating Losses in that definition are cumulative). Accordingly, the Developer's Operating Losses from the early years of the Retail Ground Lease are properly considered part of Developer's equity investment and included in the DEI calculation.

Furthermore, the assertion of the City's auditor that only the Operating Losses for the specific period in question be included in the DEI calculation is illogical as there would never be NIAD in any year when there are Operating Losses in that year. Thus, it had to have been the intention of the drafters of the Retail Ground Lease that the Operating Losses in the DEI calculation be cumulative. *See Am. Home. Assur. Co. v. Larkin Gen. Hosp., Ltd.*, 593 So. 2d 195, 197 (Fla. 1992) (a contract is construed in accordance with the intent of the parties to the contract).

Even if, for the sake of argument, the City's auditor is correct in concluding that Developer should not include cumulative Operating Losses in the DEI calculation, Developer has consistently done so for over 20 years and this practice, to our knowledge, has never been challenged by the City or any of the City's prior auditors (of which there have been many over the years). "A court may consider the conduct of the parties through their course of dealings to determine the meaning of a written agreement." *Haddad v. Hester*, 964 So. 2d 707, 711 (Fla. 3d DCA 2007) (citing *Oakwood Hills v. Horacio Toledo, Inc.*, 599 So. 2d 1374, 1376 (Fla. 3d DCA 1992)). Under Florida jurisprudence, it is well-settled that the parties' subsequent conduct can modify the terms in a contract. *St. Joe Corp. v. McIver*, 875 So. 2d 375, 382 (Fla. 2004); *accord Kiwanis Club of Little Havana, Inc. v. de Kalafe*, 723 So. 2d 838, 841 (Fla. 3d DCA 1998). Alternatively, the doctrine of equitable estoppel operates to prevent gross inequity where one party's prior conduct "invite[d] another onto a welcome mat and then … snatch[ed] the mat away to the detriment of the party induced." *Castro v. Miami-Dade Cnty. Code Enforcement*, 967 So. 2d 230, 234 (Fla. 3d DCA 2007) (citations omitted).

<u>NET PROCEEDS FROM LEASEHOLD MORTGAGES AND SALE-SUBLEASEBACK TRANSACTIONS</u>

The City's auditor has questioned the reason that Developer revised the DEI calculation to $111.5 million and has asserted that the NIAD calculation should include (or more accurately, the DEI calculation should exclude) net proceeds totaling $68 million. The reason Developer contends that the DEI calculation from and after August 3, 2012 should exclude net proceeds is simply because Developer paid off the financing secured by Leasehold Mortgages encumbering both the Retail Parcel and the Parking Garage Parcel in its entirety on that date. There is presently no outstanding financing at Bayside Marketplace (with the exception of the bonds on the Parking Garage Ground Lease and there remains only one outstanding payment on the bonds due July 1, 2014 in the amount of $1,255,000). As such, Developer's equity investment in the Retail Parcel for the period from August 3, 2012 through December 31, 2012 should be the sum of (i) Development Cost ($68,536,467) plus (ii) unrecouped and unfinanced Capital Improvement costs ($27,307,892) plus (iii) Operating Losses ($15,677,651) less (iv) net proceeds from Leasehold Mortgages ($0) for a total DEI of $111,522,010. This number is slightly higher for 2013, as detailed in the subsequent calculation provided by Developer to the City, as there were additional Capital Improvement costs incurred by Developer in 2013.

Because Developer's investment in the Retail Parcel since August 3, 2012 is solely equity, the approach of the City's auditor would actually penalize Developer for having paid off its prior financing without concurrently refinancing. Furthermore, since August 3, 2012, Developer has not reduced NIAD by debt service on the Retail Parcel (which it would otherwise be entitled to do pursuant to clause (2) of the NIAD definition) or the Parking Garage parcel (except for the annual payments due with respect to the bonds). The suggestion by the City's auditor that net proceeds of $68 million should be factored into the DEI calculation (based upon the original loan proceeds) is inconsistent with the plain drafting of the DEI definition (i.e., why would the drafters of the Retail Ground Lease include clauses (i) (Development Cost = $68.5 million) and (iv) (net proceeds = $68 million) in the DEI definition if these figures would consistently offset each other?). If that were the true intent, then Developer's equity would consist solely of Operating Losses plus unrecouped and unfinanced Capital Improvement costs since initial construction which could not be the intent of the provision as written.

Developer has not recouped the initial or any subsequent equity that it has invested in Bayside Marketplace and essentially invested additional equity when it paid off the most recent financing in August, 2012. Accordingly, from and after August, 2012, until such time as Developer obtains new financing secured by one or more Leasehold Mortgages, net proceeds for purposes of clause (iv) of the DEI calculation should be zero.

We appreciate your consideration and look forward to resolving the foregoing issues as soon as possible. Please don't hesitate to contact either John Charters (508.647.4962) or Marjorie Zessar (312.960.5079) with any questions. Thank you.

Very truly yours,

BAYSIDE MARKETPLACE, LLC

By:____________________
Authorized Signatory

cc: Mark Burns, via email
Veronica Xiques, via email
Lucia Dougherty, via email
John Charters, via email
Marjorie Zessar, via email