

MORGAN HILL REDEVELOPMENT AGENCY

Review Report

ASSET TRANSFER REVIEW

January 1, 2011, through January 31, 2012



JOHN CHIANG
California State Controller

August 2012



JOHN CHIANG
California State Controller

August 28, 2012

J. Edward Tewes, City Manager
City of Morgan Hill
17575 Peak Avenue
Morgan Hill, CA 95037

Dear Mr. Tewes:

Pursuant to Health and Safety (H&S) code section 34167.5, the State Controller's Office reviewed all asset transfers made by the Morgan Hill Redevelopment Agency to the City of Morgan Hill or any other public agency during the period of January 1, 2011, through January 31, 2012. As you know, this statutory provision explicitly states that, "The Legislature hereby finds that a transfer of assets by a redevelopment agency during the period covered in this section is deemed not to be in furtherance of the Community Redevelopment Law and is thereby unauthorized." Therefore our review also included an assessment of whether each asset transfer was allowable and whether it should be returned to the Morgan Hill Redevelopment Successor Agency.

The review applied to all assets, including but not limited to, real and personal property, cash funds, accounts receivable, deeds of trust and mortgages, contract rights and any rights to payment of any kind. We also reviewed and determined whether any unallowable transfers of assets to the City of Morgan Hill or any other public agencies have been reversed.

Our review disclosed that the Morgan Hill Redevelopment Agency transferred \$228,316,019 in assets. This included unallowable transfers of \$108,436,367, or 47.5% of assets to the City of Morgan Hill and the Morgan Hill Economic Development Corporation. Pursuant to H&S Code section 34167.5, the City of Morgan Hill and the Morgan Hill Economic Development Corporation are ordered to reverse all unallowable transfers identified in this report and return them to the Morgan Hill Redevelopment Successor Agency.

If you have any questions, please contact Steven Mar, Chief, Local Government Audits Bureau, at (916) 324-7226.

Sincerely,

Original signed by

JEFFREY V. BROWNFIELD
Chief, Division of Audits

JVB/sk

cc: Kevin Riper, Finance Director
City of Morgan Hill
Don Gage, Chairman
Oversight Board-Morgan Hill RDA Successor Agency
Steven Tate, Chairman
Morgan Hill Economic Development Corporation
Vinod Sharma, Director of Finance
County of Santa Clara
Irene Lui, Controller-Treasurer
County of Santa Clara
Steve Szalay, Local Government Consultant
California Department of Finance
Richard J. Chivaro, Chief Counsel
State Controller's Office

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Asset Transfer Review Report

Summary

The State Controller's Office (SCO) reviewed the asset transfers made by the Morgan Hill Redevelopment Agency for the period of January 1, 2011, through January 31, 2012. Our review included, but was not limited to, real and personal property, cash funds, accounts receivable, deeds of trust and mortgages, contract rights, and any rights to payments of any kind from any source.

Our review disclosed that the Morgan Hill Redevelopment Agency transferred \$228,316,019 in assets, including unallowable transfers of assets of \$108,436,367, or 47.5% of the transferred assets. Those assets must be returned to the Successor Agency.

Background

In January of 2011, the Governor of the State of California proposed statewide elimination of redevelopment agencies (RDAs) beginning with the fiscal year (FY) 2011-12 State budget. The Governor's proposal was incorporated into Assembly Bill 26 (ABX1 26, Chapter 5, Statutes of 2011, First Extraordinary Session), which was passed by the Legislature, and signed into law by the Governor on June 28, 2011.

ABX1 26 prohibited RDAs from engaging in new business, established mechanisms and timelines for dissolution of the RDAs, and created RDA Successor Agencies to oversee dissolution of the RDAs and redistribution of RDA assets.

A California Supreme Court decision on December 28, 2011 (California Redevelopment Association et al. v. Matosantos) upheld ABX1 26 and the Legislature's constitutional authority to dissolve the RDAs.

On June 27, 2012, the Governor signed a trailer bill, AB 1484 (Chapter 26, Statutes of 2012), which clarified provisions of ABX1 26, and imposed new tasks on county auditor-controllers and Successor Agencies related to RDA dissolution.

ABX1 26 and AB 1484 were codified in the Health and Safety Code (H&S Code) beginning with section 34161.

In accordance with the requirements of H&S Code section 34167.5, the State Controller is required to review the activities of RDAs, "to determine whether an asset transfer has occurred after January 1, 2011, between the city or county, or city and county that created a redevelopment agency or any other public agency, and the redevelopment agency," through the date at which the RDA ceases to operate, or January 31, 2012, whichever is earlier.

The SCO has identified transfers of assets that occurred during that period between the Morgan Hill Redevelopment Agency, the City of Morgan Hill, and/or other public agencies. By law, the State Controller is required to order that such assets, except those that already had been committed to a third party prior to June 28, 2011 (effective date of ABX1 26), be returned to the Successor Agency. In addition, the SCO may file a legal order to ensure compliance with this order.

Objective, Scope, and Methodology

Our review objective was to determine whether asset transfers that occurred after January 1, 2011, and the date upon which the RDA ceased to operate, or January 31, 2012, whichever was earlier, between the city or county, or city and county that created an RDA, or any other public agency, and the RDA, were appropriate.

We performed the following procedures:

- Interviewed Successor Agency personnel to gain an understanding of the Successor Agency operations and procedures.
- Reviewed meeting minutes, resolutions, and ordinances of the city council, the Morgan Hill Redevelopment Agency, and the Morgan Hill Economic Development Corporation (MHEDC).
- Reviewed accounting records relating to the recording of assets.
- Verified the accuracy of the Asset Transfer Assessment Form. This form was sent to all former RDAs to provide a list of all assets transferred between January 1, 2011, and January 31, 2012.
- Reviewed applicable financial reports to verify assets (capital, cash, property, etc.).

Assembly Bill (AB) 1484 was passed on June 27, 2012, adding Health & Safety Code section 34178.8 which states “. . .the Controller shall review the activities of successor agencies in the state to determine if an asset transfer has occurred after January 31, 2012. . . .”

The SCO has not completed the review associated with AB 1484 because the ABX1 26 asset transfer review was completed prior to the passage of AB 1484.

Conclusion

Our review disclosed that the Morgan Hill Redevelopment Agency transferred \$228,316,019 in assets during the period of January 1, 2011 through January 31, 2012, including unallowable transfers of assets totaling \$108,436,367, or 47.5% of the transferred assets. Those assets must be returned to the Successor Agency for use in paying off all allowable obligations and bond debt.

Unallowable Assets Transferred:

Unallowable assets transferred to City of Morgan Hill (see Schedule 1)	\$ 88,635,765
Unallowable assets transferred to MHEDC (see Schedule 2)	<u>19,800,602</u>
Total unallowable transfers	<u>\$ 108,436,367</u>

The agencies named above as recipients of the unallowable asset transfers are ordered to immediately reverse the transfers, and return the assets identified in this report to the Successor Agency (see Schedules 1 and 2).

Details of our findings are in the Findings and Orders of the Controller section of this report. We also have included a detailed schedule of assets to be returned to the Successor Agency.

**Views of
Responsible
Official**

We issued a draft audit report on July 23, 2012. J. Edward Tewes, City Manager, responded by letter dated August 2, 2012, disagreeing with the audit results. The city's response is included in this final review report as an attachment.

Restricted Use

This report is solely for the information and use of the City of Morgan Hill, the Morgan Hill Economic Development Corporation, the Morgan Hill Redevelopment Successor Agency, the Successor Agency Oversight Board, and the SCO; it is not intended to be and should not be used by anyone other than these specified parties. This restriction is not intended to limit distribution of this report, which is a matter of public record.

Original signed by

JEFFREY V. BROWNFIELD
Chief, Division of Audits

August 28, 2012

Findings and Orders of the Controller

FINDING 1— Unallowable asset transfers to the City of Morgan Hill

The Morgan Hill Redevelopment Agency (RDA) transferred \$88,635,765 in assets to the City of Morgan Hill (City). Per the City Staff Report, dated January 28, 2011, approved by the Assistant City Manager and submitted by the Executive Director of the MHRA, the purpose of the asset transfers was to protect redevelopment agency resources from the dissolution of the RDA. All of the asset transfers to the City of Morgan Hill occurred during the period of January 1, 2011, through January 31, 2012, and the assets were not contractually committed to a third party prior to June 28, 2011. Those assets consisted of cash and capital assets.

Unallowable Asset Transfers, Capital Assets:

In February and March of 2011, the RDA transferred capital assets of \$83,207,948 in land and improvements to the City. To accomplish those transfers, the City and the RDA entered into an agreement under Resolutions MHRA-333, MHRA-334, and MHRA-339. Based on H&S Code section 34167.5, the RDA was not allowed to transfer physical assets or cash to a public agency after January 1, 2011.

City's Response

Draft Review Finding 1, 1st bullet, page 4: "In February and March 2011, the RDA transferred capital assets of \$83,207,948 in land and improvements to the City. . . . the RDA was not allowed to transfer physical assets or cash to a public agency after January 1, 2011."

Agree in part. The transfers of capital assets were not unlawful at the time they were made. They were legally documented; and were approved in an open, noticed public meeting. We do agree, however, that the legal transfers of capital assets are subject to retroactive invalidation and, to the extent such transferred assets have not been committed to third parties, they are subject to claw back per ABXl 26. Therefore, the City will return the capital assets to the Successor Agency for subsequent disposition or transfer to the City as directed by the Oversight Board.

SCO's Comment

The State Controller's Office is in agreement with the City of Morgan Hill.

Unallowable Asset Transfers, Cash – Capital Improvements:

On February 24, 2011, the RDA transferred \$2,430,000 in cash to the City for future capital improvements and replacement costs for all building systems and equipment for all RDA capital assets that were transferred. Pursuant to H&S Code section 34167.5, the RDA was not allowed to transfer physical assets or cash to a public agency after January 1, 2011.

City's Response

Draft Review Finding 1, 2nd bullet, page 4: "On February 24, 2011, the RDA transferred \$2,430,000 in cash to the City for future capital improvements and replacement costs for all building systems and equipment for all RDA capital assets that were transferred the RDA was not allowed to transfer physical assets or cash to a public agency after January 1, 2011."

The transfers of cash were not unlawful at the time they were made. They were legally documented; and were approved in an open, noticed public meeting. We do agree, however, that the legal transfers of cash are subject to retroactive invalidation and, to the extent such transferred assets have not been committed to third parties, they are subject to claw back per ABXI 26. Of the \$2,430,000 transferred, the amount of \$186,923 was the RDA's obligation for FY 11-12, which has now been discharged. Therefore, the City will return to the Successor Agency all but \$186,923 of the \$2,430,000. The Successor Agency will, in turn, convey the cash to the County Auditor-Controller for disbursement to the underlying taxing jurisdictions as directed by ABXI 26.

SCO's Comment

The State Controller's Office is in agreement with the City of Morgan Hill. The amount that should be transferred back is \$2,243,077.

Unallowable Asset Transfers, Cash – Lease Prepayment:

On February 24, 2011, the RDA transferred \$2,002,000 in cash to the City for advance payment to prepay the lease, which expires in 2024, for 5,700 square feet of space to house the RDA/Successor Agency. As noted in the City Staff Report, dated January 28, 2011, approved by the Assistant City Manager, and submitted by the Executive Director of the MHRA, the purpose of the asset transfers was to protect redevelopment agency resources from the elimination of the RDA (RDA Staff Report meeting dated February 16, 2011).

Prior to January 1, 2011, the RDA was paying the city \$154,000 on an annual basis for the lease. The calculation for the lease payment was based on market rates for similar quality office space in the City at a rate of \$2.25 per square foot, per month, for approximately 5,700 square feet of lease. While 25 employees may have worked in the space provided, the amount of time actually worked on RDA activities was less than 100%. Therefore, the lease payment was overstated by the amount of time the space was used by employees to work on City activities.

The City is required to return the entire amount back to the Successor Agency for disposition because the calculation did not reflect the amount of time used by the RDA. The Successor Agency is directed to use its authority under H&S Code section 34177 to revise the lease and calculate the revised annualized lease payments that should have been

made by the RDA for the period through January 31, 2012, and which should be made by the Successor Agency from February 1, 2012, until it ceases operations. Such payments are required to be included on a Recognized Obligation Payment Schedule (ROPS) and approved for payment by the Department of Finance.

City's Response

Draft Review Finding 1, 3rd bullet, page 4: "On February 24, 2011, the RDA transferred \$2,002,000 in cash to the City for advance payment to prepay the lease ... of space to house the RDA/Successor Agency The City is required to return the entire amount back to the Successor Agency for disposition because the calculation did not reflect the amount of time used by the RDA. The Successor Agency is directed to use its authority ... to revise the lease and calculate the revised annualized lease payments that should have been made by the RDA ... and which should be made by the Successor Agency Such payments are required to be included on a Recognized Obligations Payment Schedule (ROPS) and approved for payment by the Department of Finance."

Agree in part. The City agrees that the lease contract is subject to the retroactive invalidation of contracts between the former Agency and the City (H&S §34178(a)). The City disagrees, however, with the Draft Review's direction to "use its (Successor Agency's) authority ... to revise the lease and calculate the revised annualized lease payments that should have been made by the RDA"

While the Controller has the statutory authority to order the return of assets, he is without authority to dictate the nature or amount of enforceable obligations. The Oversight Board (with approval by the Department of Finance) has the authority to approve the re-entering of the lease agreement (H&S §34178(a)). It is also notable that under AB 1484, the Successor Agency has the additional authority to create enforceable obligations to conduct the work of winding down the Redevelopment Agency (H&S §34177.3(b)).

Even if the Controller has some authority to order the revision of the lease payment amount, the suggested method of lease calculation is based on faulty assumptions. The annual lease amount of \$154,000 is tied to a portion of the annual debt service the City pays to bondholders who financed construction of the office building that the former RDA and, now, the Successor Agency occupies. The building and the bond issue that financed it were sized on the reasonable assumption that the former RDA would be occupying an agreed-upon portion of the building based on what the RDA would need for the purposes of implementing the former RDA's Redevelopment Plan. The disappearance of the RDA does not imply the disappearance of the obligation of the Successor Agency to continue to pay the City for the costs it incurred in paying for the RDA's planned share of the space in the building. It is not unusual in commercial leasing that the tenant is obligated to pay a lease amount and commit to a lease term that would compensate the landlord for the costs of constructing and improving leased space to suit the needs of the tenant. Just because the tenant,

during the term of the lease, no longer needs the same space as contemplated at the time of the making of the lease does not obligate the landlord to adjust either the amount or the term of the lease. Neither is it unheard of for the tenant to prepay a lease for years in order to compensate the landlord upfront for the cost of the improvements of the tenant space.

SCO's Comment

The State Controller's Office is in agreement with the City of Morgan Hill/RDA Successor Agency comment that "the lease contract is subject to the retroactive invalidation of contracts. . . ." The SCO also agrees that any revision of the contract shall be decided and approved by the Oversight Board and State Department of Finance. The City is ordered by the Controller to return \$1,848,000 of the remaining balance after the rent payment of \$154,000.

Unallowable Asset Transfers, Cash – Advance Payment for Reconstruction:

On February 24, 2011, the RDA transferred \$977,000 in cash to the City for advance payment for the reconstruction of RDA-owned parking lots. To accomplish this transfer, the City and the RDA entered into an agreement under Resolution MHRA-334. Based on H&S Code section 34167.5, the RDA was not allowed to transfer physical assets or cash to a public agency after January 1, 2011.

City's Response

Draft Review Finding 1, 4th bullet, page 5: "On February 24, 2011, the RDA transferred \$977,000 in cash to the City for advance payment for the reconstruction of RDA-owned parking lots. To accomplish this transfer, the City and the RDA entered into an agreement the RDA was not allowed to transfer physical assets or cash to a public agency after January 1, 2011."

Agree in part. The transfers of land and cash were not unlawful at the time they were made. They were legally documented; and were approved in an open, noticed public meeting. We do agree, however, that the legal transfers of assets are subject to retroactive invalidation and, to the extent such transferred assets have not been committed to third parties, they are subject to claw back per ABX1 26. The City will return the \$977,000 of cash to the Successor Agency and ask the Oversight Board to consider approving a transfer of ownership of the former RDA-owned parking lots to the City.

SCO's Comment

The State Controller's Office is in agreement with the City of Morgan Hill.

Unallowable Asset Transfers, Cash – Unfunded PERS Obligation:

On March 7, 2011, the RDA transferred \$1,300,000 in cash to the City for an unfunded advance Public Employee Retirement System (PERS) obligation. This amount was never budgeted, appropriated, or encumbered by the RDA. While the RDA is liable for its actual share of the PERS obligation, there is no accurate documentation calculating the actual amount of this obligation. The entire amount should be returned to the Successor Agency and the City may re-bill the Successor Agency for the actual amount incurred on behalf of the RDA. The bill is required to be included on a ROPS and approved for payment by the Department of Finance.

City's Response

Draft Review Finding 1, 5th bullet, page 5, First sentence: "On March 7, 2011, the RDA transferred \$1,300,000 in cash to the City for an unfunded advance Public Employee Retirement System (PERS) obligation."

[City] Agree.

SCO's Comment

The City agreed.

City's Response

Finding, 2nd sentence: "This amount was never budgeted, appropriated, or encumbered by the RDA."

Disagree. The Redevelopment Agency Board authorized the transfer at its meeting of January 26, 2011, and amended the FY 10-11 RDA budget to reflect the transaction at its meeting of April 20, 2011.

SCO's Comment

We have re-examined the supporting data and agree with the City. Therefore, we have revised the finding accordingly.

City's Response

Finding, 3rd sentence: "While the RDA is liable for its actual share of the PERS obligation, there is no accurate documentation calculating the actual amount of this obligation."

Disagree. City staff provided the State Controller's Office with detailed calculations underlying the \$1.3 million unfunded accrued actuarial liability -- calculations at a level of detail that even CalPERS itself was, and is, incapable of generating. Staff also provided proof to the State Controller's Office auditors that the \$1.3 million had been paid to CalPERS.

SCO's Comment

We have re-examined the supporting data for the PERS payment and have concluded that the payment is valid. Therefore, we revised the finding accordingly.

City's Response

Finding, 4st and 5th sentences: "The full amount should be returned to the Successor Agency and the City may re-bill the Successor Agency for the actual amount of costs incurred on behalf of the RDA. The bill is required to be included on a ROPS and approved for payment by the Department of Finance."

Comment: Disagree. The pension payments made to CalPERS (a third party) were made to satisfy pension obligations that had *already* been incurred for the period of the employment of RDA employees prior to the enactment of ABX1 26. So, the order to transfer back and place such obligation on the ROPS is both unsupported by law and impossible to do. First, the Controller has the power to order the transfer back of assets only if the City "is not contractually committed to a third party for the expenditure or encumbrance" (H&S §34167.5). Pension obligations were in fact an incurred obligation to a third party beyond the Controller's power to claw back. Second, nothing in either ABX1 26 or AB 1484 requires the City as Successor Agency to place on a ROPS—years after it has already been incurred and paid—a payment obligation made in good faith prior to the enactment of ABX1 26. Third, it is impossible to return the funds to the Successor Agency, because the City does not have them; CalPERS does. Nothing in the law requires, and in fact it would be unconstitutional to require, the City to pay to the Successor Agency moneys from other funds of the City. Therefore, we respectfully request that your division remove this finding altogether. If you need another copy of the detailed calculations, please ask the City's Finance Director or Assistant Finance Director.

SCO's Comment

We have re-examined the supporting data for the PERS payment and have concluded that the payment is valid. Therefore, we revised the finding accordingly.

Unallowable Asset Transfer, Cash – Unemployment Insurance:

On March 7, 2011, the RDA transferred \$391,050 in cash to the City for the purpose of paying Unemployment Insurance claims for RDA staff who were laid off. The City used the highest salary to determine the estimated amount to be paid into the unemployment fund. This amount was never budgeted, appropriated, or encumbered by the RDA. While the RDA is liable for its actual share of Unemployment Insurance claims, there is no documentation calculating the actual amount of this obligation. The full amount should be returned to the Successor Agency and the City may re-bill the Successor Agency for the actual amount of costs incurred on behalf of the RDA. The bill is required to be included on a ROPS and approved for payment by the Department of Finance.

City's Response

Draft Review Finding 1, 6th bullet, page 5, 1st and 2nd sentences: "On March 7, 2011, the RDA transferred \$391,050 in cash to the City for the purpose of paying Unemployment Insurance claims for RDA staff who were laid off. The City used the highest salary to determine the estimate amount to be paid into the unemployment fund."

Agree, but please change "salary" to "weekly benefit" in this sentence. Every affected employee earned a high enough salary to qualify for the maximum unemployment benefit under Federal law.

SCO's Comment

The State Controller's Office is in agreement with the City of Morgan Hill.

City's Response

Finding, 3rd sentence: "This amount was never budgeted, appropriated, or encumbered by the RDA."

Disagree. The Redevelopment Agency Board authorized the transfer at its meeting of January 26, 2011, and amended the FY 10-11 RDA budget to reflect the transaction at its meeting of April 20, 2011.

SCO's Comment

We have re-examined the supporting data and agree with the City of Morgan Hill.

City's Response

Draft Review Finding 1, 6th bullet, remaining sentences: "While the RDA is liable for its actual share of Unemployment Insurance claims, there is no documentation calculating the actual amount of this obligation. The full amount should be returned to the Successor Agency and the City may re-bill the Successor Agency for the actual amount of costs incurred on behalf of the RDA. The bill is required to be included on a ROPS and approved for payment by the Department of Finance."

Agree in part. As you point out at the top of page 2, "By law, the State Controller is required to order that such assets, *except those that already had been committed to a third party prior to June 28, 2011* (effective date of ABX1 26), be returned" (Emphasis added) Obviously, unemployment benefits were committed to both EDD and the laid-off RDA staff prior to June 28. Finally, as noted in the section immediately above, Section 34171(d)(1)(B) defines unemployment payments as enforceable obligations, similar to pension payments. Indeed, laid-off employees are still collecting unemployment benefits as of this writing, and may continue to do so—up to the maximum of 99 weeks authorized under Federal law. Therefore, the city will return

all but the \$31,310 expended on unemployment benefits already received by former RDA staff through March 31, 2012, plus the (not yet known from EDD) amount claimed by those former employees since then. For future unemployment claims, the City will take the recommended action and put them on a ROPS for approval.

SCO's Comment

The State Controller's office is in agreement with the City of Morgan Hill. Therefore, we revised the finding accordingly.

Pursuant to H&S Code section 34167.5, the RDA may not transfer assets to a city, county, city and county, or any other public agency after January 1, 2011. Those assets should be returned to the Successor Agency for disposition in accordance with H&S Code section 34177 (d) and (e). However, it appears that some of those assets also may be subject to the provisions of H&S Code section 34181(a). H&S Code section 34181(a) states, "The oversight board shall direct the successor agency to do all of the following:

(a) Dispose of all assets and properties of the former redevelopment agency that were funded by tax increment revenues of the dissolved redevelopment agency; provided however, that the oversight board may instead direct the successor agency to transfer ownership of those assets that were constructed and used for a government purpose, such as roads, school buildings, parks, and fire stations, to the appropriate public jurisdiction pursuant to any existing agreements relating to the construction or use of such as asset...."

Order of the Controller

Based on H&S Code section 34167.5, the City of Morgan Hill is ordered to reverse the transfer of the above assets, described in Schedule 1 and Attachment 1, in the amount of \$88,635,765 plus interest earned, and return them to the Successor Agency.

The Successor Agency is directed to properly dispose of those assets in accordance with H&S Code sections 34177(d) and (e) and 34181(a). As noted, the City may re-bill the Successor Agency for actual amounts incurred on behalf of the RDA or Successor Agency for lease payments, reconstruction costs, and Unemployment Insurance claims.

**FINDING 2—
Unallowable transfers
to the Morgan Hill
Economic Development
Corporation**

The Morgan Hill Redevelopment Agency (RDA) transferred \$19,800,602 in assets to the newly created Morgan Hill Economic Development Corporation (MHEDC) in March of 2011. Per the City Staff Report, dated January 28, 2011, approved by the Assistant City Manager and submitted by the Executive Director of the RDA, it appears the purpose of the asset transfers was to protect RDA resources from the elimination of the RDA. All of the asset transfers occurred during the period of January 1, 2011, through January 31, 2012, to the MHEDC, an agency described under H&S Code section 34167.10. The assets were not contractually committed to a third party prior to June 28, 2011. The assets consisted of cash and capital assets.

The unallowable asset transfers were as follows:

- The RDA transferred capital assets of \$13,896,553 in land and improvements to the city. On March 29, 2011, the City transferred the assets back to the RDA. This transfer was implemented by an agreement between the city and RDA under Resolution 6410. Also on March 29, 2011, the RDA sold the assets to the MHEDC for \$1, under Resolution 6411. Although Resolution 6410 was signed, the records of the Morgan Hill Redevelopment Agency do not show that the assets were transferred first to the City and then back to the RDA, only that the assets were being transferred from the RDA to the MHEDC.
- On March 16, 2011, the RDA transferred \$4,128,000 in cash to the MHEDC by Resolution MHEDC-002, to provide development services to the Morgan Hill Redevelopment Agency in the City's downtown area in conformance with the City's Downtown Specific Plan.
- On June 30, 2011, the RDA transferred \$71,049 in investment property to the MHEDC to be held for resale.
- On June 30, 2011, the RDA transferred \$1,705,000 in an Option Agreement to the MHEDC. The Option Agreement, owned by the RDA, was to exercise an option to purchase certain properties.

The following statements were made at various meetings regarding the protection of redevelopment assets:

- On January 26, 2011, at a Joint Regular City Council and Redevelopment Agency Meeting, City Manager Ed Tewes stated, "Some have been concerned that those assets would be swept away by the successor agency to buy down the debt." Mayor Tate then stated, "other cities have gone beyond what you are proposing and have tried to protect the whole amount somehow."
- On February 16, 2011, at a Joint Regular City Council and Redevelopment Agency Meeting, Council Member Carr stated, "...our job is to protect Morgan Hill. People may wonder what the actions that the City Council and Redevelopment Agency are taking; they are to protect the City." City Attorney Wan stated "the actions are something that agencies do quite often. It is the prevalent practice

that when the communities build those facilities the cities own them. We are taking actions that we would want to take whether the RDA was going away or not.”

- On March 23, 2011, at a Joint Regular City Council and Redevelopment Agency Meeting, City Manager Ed Tewes stated, “the city has taken all the reasonable steps to protect the resources generated here in Morgan Hill for the benefit of the City, but it is possible that the city will still have to fight for those funds if the trailer bill passes.” He also stated, “if Council takes this action there will be a greater degree of comfort that the concept design of this project can be completed because the city would have entered into a third-party contract prior to the effective date of the trailer bill.”

City Attorney Wan stated, “it is unclear who would have the authority to approve spending once the trailer bill passes and it is even questionable whether this oversight committee, or the successor agency will have the authority to recognize any contract passed after January 1, 2011...[I]f there is a contract with a third party there is at least an argument that if contracts are entered into and are being performed then the successor agency needs to continue to honor them, but it is still unclear what the legislation actually states.”

Mayor Tate stated, “it was a shame the process had to be fast tracked but that the shame was on the State for putting such pressure on the city.”

The MHEDC was created and the Articles of Incorporation signed on March 2, 2011, to carry on the functions of the RDA by providing development services in the City’s downtown area in conformance with the City’s Downtown Specific Plan. The initial Board of Directors consisted of all City Council Members. They were:

Steven Tate, Mayor/City Council Member
Larry Carr, City Council Member
Richard Constantine, City Council Member
Marilyn Librers, City Council Member
Gordon Siebert, City Council Member

On March 7, 2012, a meeting was held to replace the members of the Board of Directors to create some independence with an “arm’s length” distance between the private nonprofit corporation and the City itself. However, there is no official signed documentation or resolution confirming the change. Also, all of the unallowable transfers described previously were made during the period when the City Council still was sitting as the Board of Directors of the MHEDC. Below is a list of the then-proposed new Board of Directors’ members:

Greg Sellers, President of Burnham Solar
Brad Krouskup, President and CEO of Toeniskoetter
Development
Laura Gonzalez-Escoto, former employee of several
RDAs

Doug Moffat, Senior Vice President of Pinnacle Bank
Howard Allred, CFO of Specialized Bicycles
Larry Carr, City Council Member
Gordon Siebert, City Council Member

Pursuant to provisions of H&S Code section 34167.5, the RDA may not transfer assets to a city, county, city and county, or any other public agency after January 1, 2011. The City contends that the MHEDC is a public nonprofit corporation created to provide charitable or other public purposes and that transfers from the RDA to the MHEDC are not prohibited under H&S Code section 34167.5. However, H&S Code section 34167.10 states the following:

34167.10. (a) Notwithstanding any other law, for purposes of this part and Part 1.85 (commencing with Section 34170), the definition of a city, county, or city and county includes, but is not limited to, the following entities:

- (1) Any reporting entity of the city, county, or city and county for purposes of its comprehensive annual financial report or similar report.
- (2) Any component unit of the city, county, or city and county.
- (3) Any entity which is controlled by the city, county, or city and county, or for which the city, county, or city and county is financially responsible or accountable.

(b) The following factors shall be considered in determining that an entity is controlled by the city, county, or city and county, and are therefore included in the definition of a city, county, or city and county for purposes of this part and Part 1.85 (commencing with Section 34170):

- (1) The city, county, or city and county exercises substantial municipal control over the entity's operations, revenues, or expenditures.
- (2) The city, county, or city and county has ownership or control over the entity's property or facilities.
- (3) The city, county, or city and county and the entity share common or overlapping governing boards, or coterminous boundaries.
- (4) The city, county, or city and county was involved in the creation or formation of the entity.
- (5) The entity performs functions customarily or historically performed by municipalities and financed through levies of property taxes.
- (6) The city, county, or city and county provides administrative and related business support for the entity, or assumes the expenses incurred in the normal daily operations of the entity.

(c) For purposes of this section, it shall not be relevant that the entity is formed as a separate legal entity, nonprofit corporation, or otherwise or is not subject to the constitution debt limitation otherwise applicable to a city, county, or city and county. The provisions in this section are declarative of

existing law as the entities described herein are and were intended to be included within the requirements of this part and Part 1.85 (commencing with Section 34170) and any attempt to determine otherwise would thwart the intent of these two parts.

The current relationship between the City and the MHEDC is described below with the applicable H&S Code sections identified:

- The initial controlling Board of Directors for the MHEDC were the City Council members, who previously acted as the Board of Directors of the RDA, and the corporate officers are City/RDA employees (H&S Code sections 34167.10(b)(1) and 34167.10(b)(3)).
- The City Council members had control over the disposition of the assets owned by the MHEDC (H&S Code section 34167.10(b)(2)).
- The City was responsible for creating the MHEDC (H&S Code section 34167.10(b)(4)).
- The specific charge given to the MHEDC was to continue redevelopment functions, which violates the provisions of ABX1 26 (H&S Code section 34167.10(b)(5)).
- All administrative and business support for the MHEDC is provided by the City (H&S Code section 34167.10(b)(6)).
- The City formed the MHEDC as a separate legal entity, nonprofit corporation (H&S Code section 34167.10(c)).

Order of the Controller

Based on H&S Code sections 34167.5 and 34167.10, the City is ordered to direct the MHEDC to reverse the transfer of the above assets, described in Schedule 2 and Attachment 2, in the amount of \$19,800,602, plus interest earned, and return them to the Successor Agency.

The Successor Agency is directed to properly dispose of those assets in accordance with H&S Code sections 34177(d) and (e) and 34181(a).

City's Response

Comments Relating to Finding 2 (Transfers to the MHEDC)

Draft Review, Finding 2, Entire Finding: In sum, the Finding is that because "it appears the purpose of the transfers was to protect RDA resources from the elimination of the RDA" and because the MHEDC is "an agency described under H&S Code Section 34167.10" that the transfers to the MHEDC are unallowable.

Comment: The MHEDC is a bona fide independent corporation and is NOT a "city" under H&S §34167.10. The motivations of the City Council for creating the MHEDC, which the Draft Report suggests may have included the protection of RDA assets from RDA dissolution, are

irrelevant to the analysis of whether the transfer is legal and allowable or whether the transfer is subject to the Controller's power to "claw back" [sic] the assets.

1. The MHEDC is a bona fide corporation and not a "city" or an agency of the City.

It cannot be disputed that the MHEDC is a duly incorporated domestic corporation of the State of California, organized under the Nonprofit Public Benefit Corporation Law for charitable purposes, and specifically for the primary purposes of providing "physical, economic and educational development, redevelopment and revitalization efforts with the City of Morgan Hill ..." (Articles of Incorporation, MHEDC). Even though it was first created by the City, it is organized and operated as a corporation wholly independent of the City:

- Under its bylaws, as amended at a duly organized meeting of the Corporation on March 7, 2012, the board of directors consist of 5-7 members;
- Only a maximum of 2 members may be sitting members of the City Council (MHEDC Bylaws Section 4.03(b)) and, therefore, the majority of the Board members are always non-City Council members independent of the City's control;
- The Board holds its meetings at a time and place different and apart from City Council meetings;
- The Board has hired its own legal counsel;
- The Board has obtained insurance covering MHEDC assets; and
- The Board has made the necessary filings with the Internal Revenue Service.

As such, the MHEDC fails to meet the definition of a "city" under H&S §34167.10:

- According to the City's independent auditor, the MHEDC is not a component unit of the City since March 7, 2012 when its bylaws were amended, for reporting purposes or for the purposes of its comprehensive annual financial report. Therefore, the MHEDC does not meet the definitions of a city under H&S §34167.10(a) (1) or (2).
- MHEDC does not meet the definition of a "city" under H&S §34167.10(a)(3) ("any entity which is controlled by the city ...").
 - o Other than certain reporting and use requirements regarding the assets transferred to the MHEDC pursuant to then existing Redevelopment Law and an Operating Agreement dated March 8, 2011, the MHEDC board has complete control and discretion over its own assets, operation, revenues and expenditures. Other than the initial seed funding comprised of assets transferred by the RDA, the City is not obligated, and has no intention, to further support or contribute to the MHEDC. The MHEDC has control over its operation, expenditures and revenues. The MHEDC has its own corporate powers to raise its own revenues.

- o All assets of the MHEDC are held in the corporation's title. The City has no ownership or control over MHEDC assets, including the assets transferred to the MHEDC.
 - o The MHEDC has an independent board having no more than 2 City Council members (out of 5-7 board members) and its boundaries are not coterminous with that of the former RDA (the MHEDC covers the entire City of Morgan Hill, which is larger than the former Redevelopment Area).
 - o Even though the City did form the MHEDC, the clear intent from the outset of the Corporation was to create an independent corporation.
 - o The MHEDC's purpose is to improve "the physical, economic and educational development, redevelopment and revitalization efforts within the City of Morgan Hill", which are not the customary functions performed by *municipalities through levies of property taxes*. It should be noted that such functions were some of the functions of the former RDA, but the *RDA was not a "municipality"* (it was an agency of the State) *and had no power to levy property taxes*. The historical and customary functions of the City are public safety, health & welfare and land use.
 - o The City provides administrative and business support for the MHEDC *only through an executed agreement for reimbursement of such expenses by the MHEDC to the City*, as a temporary measure until the MHEDC may hire its own staff. The City does not assume the expense of normal daily operations of the MHEDC.
2. The MHEDC is not a city and the transfers to it by the RDA under former Redevelopment Law are allowable, even if "it appears that the purpose of the asset transfer was to protect RDA resources from the elimination of the RDA."

It is well established rule of judicial interpretation that "the possible improper motivations of the Legislature or its members in passing legislation are immaterial to questions involving the validity of such legislation" *County of Los Angeles v. Superior Court*, 13 Cal.3d 721, 728 (1975). Therefore, in looking at whether the transfers from the RDA to the MHEDC were permissible, a court will not delve into the motivations of the former RDA board when it adopted the legislation to transfer assets. It would be irrelevant whether the RDA's purpose was to "protect RDA resources" as long as the MHEDC is a bona fide corporation to which the RDA could legally transfer assets under the then existing Redevelopment Law.

In *City of Cerritos v. Cerritos Taxpayers Assn.*, 183 Cal.App.4th 1417 (2010), the court of appeal upheld an arrangement in which the Cerritos Redevelopment Agency transferred land and financial assets to a nonprofit corporation formed by the City of Cerritos so that the nonprofit corporation could develop low and moderate income housing. In that case, the Cerritos Taxpayers Assn contended that the City created the nonprofit corporation only to escape the requirement under Article XXXIV, §1 of the California Constitution that a majority of voters must approve the construction of low income housing by *any state public body*. The association contended that the nonprofit organization was merely a "shell

corporation” controlled by the City and Agency intended to skirt the voter approval requirement of *public agency* housing projects. The court observed that the nonprofit board members were the same members as the city council, though the city intended to transition into a permanent board of members of the public. Even with such observation, the court held that the corporation is a private corporation and the housing project it will construct is “privately owned” and not subject to the voter requirement of a public housing project. The court held:

“We are not at liberty to ignore the corporation’s status; it has a “genuine separate existence” from the City and Agency, so “it does not matter whether or not the City ‘essentially controls’ Cuesta Villas [the nonprofit organization] The City and Agency have avoided the voter approval requirement of Article XXXIV, but the law permits what has been done.”

So here, the Controller cannot simply ignore the separate existence of the MHEDC from the City, whether under corporate law or under the tests of H&S §34167.10(a). Even if the purpose of creating the MHEDC was to protect RDA assets, the law (at the time that the EDC was formed) permitted what has been done. Based on both H&S§34167.10(a) [sic] and on case law, the Controller cannot order the City to “direct the MHEDC to reverse the transfer” of assets when the City has no control over the independent decision of the MHEDC, a bona fide nonprofit corporation.

SCO’s Comment

As stated in the report, the MHEDC was created to carry out the functions of the RDA by providing development services for the city, and its Board of Directors consisted entirely of City Council Members. Furthermore, the City had full control over the MHEDC, including the disposition of RDA assets. For all practical purposes, the MHEDC does meet the definition of a city pursuant to H&S Code sections 34167.10(a), 34167.10(b), and 34167.10(c).

The City’s assertions that the MHEDC was separate from the city and that the City had no control over the independent decisions of the MHEDC was not factually supported during our review or in the City’s response.

Schedule 1— RDA Assets Transferred to the City of Morgan Hill

	Amount
Unallowable transfers to the City of Morgan Hill:	
Capital Assets:	
Land and improvements ¹	\$ 83,207,948
Current Assets:	
Cash transfer to Fund 741 (building replacement)	2,430,000
Cash transfer to Fund 740 (building maintenance)	2,002,000
Cash transfer to Fund 346 (public facilities)	977,000
Cash transfer to Fund 791 (employee benefits)	1,300,000
Cash transfer to Fund 760 (unemployment insurance)	391,050
	\$ 90,307,998

Adjustments to Draft Report	Draft Report Amount	Adjustments	Final Report Amount
Unallowable transfers to the City of Morgan Hill:			
Capital Assets:			
Land and improvements ¹	\$ 83,207,948	\$ —	\$ 83,207,948
Current Assets:			
Cash transfer to Fund 741 (building replacement)	2,430,000	(186,923)	2,243,077
Cash transfer to Fund 740 (building maintenance)	2,002,000	(154,000)	1,848,000
Cash transfer to Fund 346 (public facilities)	977,000	—	977,000
Cash transfer to Fund 791 (employee benefits)	1,300,000	(1,300,000)	—
Cash transfer to Fund 760 (unemployment insurance)	391,050	(31,310)	359,740
	\$ 90,307,998	\$(1,672,233)	\$ 88,635,765

¹ Detail listing of assets on Attachment 1. This amount is net of depreciation.

**Schedule 2—
RDA Assets Transferred to the MHEDC**

	<u>Amount</u>
Unallowable transfers to the MHEDC:	
Capital Assets:	
Land and improvements ¹	\$ 13,896,553
Current Assets:	
Cash transfer	4,128,000
Investment (real estate option purchase)	1,705,000
Investment (land held for resale)	<u>71,049</u>
Total unallowable transfers	<u>\$ 19,800,602</u>

¹ Detail listing of assets on Attachment 2. This amount is net of depreciation.

Attachment 1

CITY OF MORGAN HILL
 RDA Assets Transferred to City
 As of 02/01/12

Schedule 1

Building/Land Improv Jul/11-Jan/12	Land	Improvements	Depreciation	Book Value	Land and Book Value
11/12		CRC PV Solar	-	2,300,465	2,300,465
		Third St/Monterey Parking Lot	-	114	114
		Third Street Parking Lot	-	360	360
10/11		Permanent Skateboard/BMX Park	-	42,930	42,930
		Library Facility	-	16,111	16,111
		Centennial Recreation Center	-	2,015	2,015
		Fitness Expansion Opportunities	-	925,918	925,918
		Marquee Sign at CCC	-	12,950	12,950
		Aquatics Center Landscape Conversion	-	9,269	9,115
		Aquatics Center	1,789,419	-	1,789,419
		CRC PV Solar	-	33,300	33,300
		Third Street/Monterey Parking lot	-	3,893	3,828
		Third Street Parking	-	213,116	209,564
		Associated Concrete	420,073	-	420,073
09/10		Outdoor Sports Complex - Fields	-	3,541	3,482
		Permanent Skateboard/BMX Park	-	52,318	51,446
		Library Facility	-	36,452	35,844
		Centennial Rec Center	-	35,670	35,076
		Parking Expansion at CRC	-	3,803	3,740
		Marquee Sign at CCC	-	103,003	101,286
		Aquatics Center Landscape Conversion	-	90,632	86,100
		Aquatics Center	-	76,650	72,818
		Depot Street Parking lot	-	40,373	38,354
		Third Street/Monterey Parking Lot	-	145,768	138,480
		Monterey Road parking lot	-	61,859	58,766
		Third Street Parking	-	103,350	98,183
		County Courthouse	-	868,053	824,650
08/09		Sports Complex-Aquatics	-	85,992	78,826
		Outdoor Sports Complex-Fields	-	76,443	72,621

	Permanent Skateboard/BMX Park	-	579,750	28,988	550,763	550,763
	Library	-	258,502	12,925	245,577	245,577
	Centennial Recreation Center	-	53,327	2,666	50,661	50,661
	Parking Expansion at CRC	-	74,073	3,704	70,369	70,369
	Fitness Expansion Opportunities	-	48,404	2,420	45,984	45,984
	Marquee Sign at CCC	-	9,453	788	8,665	8,665
	Depot Street Parking Lot	-	1,585,433	132,120	1,453,313	1,453,313
	3rd St/Monterey Parking Lot	-	125,464	10,455	115,009	115,009
	Monterey Road Parking Lot	-	30,559	2,547	28,012	28,012
	Third Street Parking	-	175	15	160	160
	Associated Concrete	3,081,570	-	-	-	3,081,570
	Hamilton Property/17575Monterey	-	29,550	2,463	27,088	27,088
	County Courthouse	-	5,286	352	4,934	4,934
07/08	Sports complex aquatics	-	264,880	26,488	238,392	238,392
	Outdoor sports complex fields	-	4,715,208	392,934	4,322,274	4,322,274
	El Toro Youth Center	-	29,750	2,479	27,271	27,271
	Library	-	15,895,070	1,324,589	14,570,481	14,570,481
	Centennial Rec Center	-	55,287	4,607	50,680	50,680
	Depot Street Parking	-	91,299	10,651	80,648	80,648
	Swing Property/Vacant lot/Capri (city)	300,000	-	-	-	300,000
	Hamilton Property/17575Monterey	208,300	475,548	55,481	420,067	628,367
06/07	Soccer Complex	-	10,100	1,178	8,922	8,922
	Sports Complex -Aquatics	-	113,382	17,007	96,375	96,375
	Sports Complex -Fields	-	2,046,890	238,804	1,808,086	1,808,086
	Indoor Rec Center (CRC)	-	4,868,886	568,037	4,300,849	4,300,849
	Depot Street Parking	-	36,044	5,407	30,637	30,637
	Public Parking Lots	-	280	42	238	238
	Soccer Complex	-	3,643	425	3,218	3,218
	Train Depot Building	-	2,290	267	2,023	2,023
	Property Based Improvement District	-	27,594	4,139	23,455	23,455
	Indoor Rec Center	-	16,883,700	1,969,765	14,913,935	14,913,935
05/06	Soccer Complex	-	3,216	429	2,787	2,787
	Sports Complex -Aquatics	-	124,469	20,745	103,724	103,724
	Sports Complex -Fields	-	415	55	360	360
	Sports Complex - Aquatics	-	57,540	9,590	47,950	47,950
	Aquatic Complex	-	688,520	114,753	573,767	573,767

04/05	Soccer Complex	-	6,960	1,160	5,800	5,800
	Sports Complex -Aquatics	-	991,089	198,218	792,871	792,871
	Community Center	-	44,393	8,879	35,514	35,514
03/04	County Courthouse	3,221,513	-	-	-	3,221,513
	Soccer complex	-	4,615	923	3,692	3,692
	Sports Complex - aquatics	-	9,599,820	2,239,958	7,359,862	7,359,862
	Soccer complex	-	833,960	180,691	653,269	653,269
	Aquatic Complex	-	74,794	18,699	56,096	56,096
	Public Parking Lots	-	13,185	3,296	9,889	9,889
	Community Rec Facility	-	186,804	40,474	146,330	146,330
	Soccer complex	-	11	11	-	-
02/03	Community Center	-	853,168	199,073	654,095	654,095
	Community Playhouse	-	13,349	3,115	10,234	10,234
	Community Center	-	142,551	33,262	109,289	109,289
	Soccer complex	-	35	35	-	-
	Sports complex - Aquatics	76,650	-	-	-	76,650
	Aquatic complex	1,147	-	-	-	1,147
	Comm Indoor Rec Center	200	-	-	-	200
	County Courthouse	100,000	-	-	-	100,000
01/02	Sports Complex - Aquatics	-	30,872	6,689	24,183	24,183
	Sports Complex - Fields	5,100,000	2,556,156	596,767	1,959,389	7,059,389
	Aquatic Complex	327,650	22,166	5,911	16,255	343,905
	Indoor Recreation Center	1,003,100	-	-	-	1,003,100
	Public Parking Lots	-	8,293	2,211	6,082	6,082
	County Courthouse	25,000	-	-	-	25,000
	Soccer Complex	-	238,188	59,863	178,325	178,325
	Library	-	128,561	29,998	98,563	98,563
00/01	Temple Emmanuel	-	-	-	-	-
	Gunderson Property (CRC)	5,502,340	-	-	-	5,502,340
99/00	Community Center	-	38,886	14,325	24,561	24,561
97/98	MH School Project	-	14,592	5,894	8,698	8,698
	4th Street Property East	-	-	-	-	-
96/97	Morgan Hill School Project	-	12,926	6,156	6,770	6,770
95/96	Depot Commons	-	16,653	8,311	8,342	8,342
	Skeels Hotel	-	16,184	8,536	7,648	7,648
91/92	Depot Center	267,120	267,120	151,368	115,752	382,872
73/74	Leased to SC Housing 50 yrs	9,345	-	-	-	9,345
Total Building & Land Improvement		21,433,427	70,653,665	8,879,144	61,774,521	83,207,948

* Difference of \$57,028 is depreciation in FY 10/11

Attachment 2—

Schedule 2

CITY OF MORGAN HILL
 MORGAN HILL ECONOMIC DEVELOPMENT CORPORATION
 FIXED ASSETS
 As of February 01, 2012

APN	Address	Description	Option to Purchase	Land	Improvements	Accumulated Depreciation 02/01/12	Book Value Improvements 02/01/12	Total Book Value 02/01/12
* 726-13-033	55 E 4th St	Vacant (house went to Pars)		197,000				
* 726-13-038	1 E Monterey Rd	Vacant					-	-
* 726-13-039	1 17270 Monterey	Single family residence					-	-
* 726-13-040	1 17280 Monterey	Liquor store		945,380	509,051	52,319	456,731	1,402,111
726-14-013	17340 Monterey	Pocket park					-	-
* 726-14-014	17380-17390 Monterey	Hencken,		320,000	1,049,567	142,858	906,709	1,226,709
* 726-14-015	30 E Second	Hencken, Third St parking			125,464	12,895	112,569	112,569
* 726-14-025	2 E Second St	Parking between 1st and 2nd				-	-	-
* 726-14-026	2 E Second St	Parking between 1st and 2nd				-	-	-
* 726-14-028	(17420-17440 Monterey	Granada Theatre			2,442,336	503,326	1,939,010	1,939,010
* 726-14-029	17450 Monterey	Building, Swing			1,336,686	181,938	1,154,748	1,154,748
* 726-14-030	17490 Monterey	Downtown mall			4,500,000	640,591	3,859,409	3,859,409
* 726-14-031	2 Downtown Mall Parking	Parking between 1st and 2nd		1,700,000		-	-	1,700,000
* 726-14-032	50 E First	Duplex just past parking lot			744,071	101,276	642,795	642,795
* 726-15-071	17295 Butterfield	Cal Train Facility		629,322	859,896	512,899	346,997	976,319
* 726-15-072	17295 Butterfield	Courthouse Plaza		882,882		-	-	882,882
* 726-13-033	Vacant 55 E Fourth St	Land held for resale		71,049			-	71,049
* 726-14-001	Booksmart/Llagas Investors	Option, not ownership	1,705,000				-	1,705,000
Totals			1,705,000	4,548,633	11,567,071	2,148,101	9,418,969	15,672,602

* Transferred from RDA 03/24/11
 1 Purchased as a block \$1,454,431 **15,672,602**
 2 Purchased as a block \$1,700,000 plus escrow **(1,705,000)**
 (71,049)
13,896,553

**Attachment 3—
City’s Response to
Draft Audit Report**



CITY MANAGER'S OFFICE
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August 2, 2012

Mr. Steven Mar, Chief, Local Government Audits Bureau
State Controller's Office
Division of Audits
P.O. Box 942850
Sacramento, CA 94250-5874

Also delivered electronically

Re: Review of Asset Transfers by Morgan Hill Redevelopment Agency

Dear Mr. Mar:

The City of Morgan Hill appreciates the opportunity to comment on your division's draft "Asset Transfer Review" of the former Redevelopment Agency ("Draft Review"). The City has a number of comments, which follow the same order as the draft report you sent us on Monday, July 23.

Background and Reservation of Rights

As a factual background, most of the assets outlined in the Draft Review were transferred to the City at a time when what became ABX1 26 was but a gleam in the Governor's eye and when the initial legislation, AB 101 (which the legislature never did pass) had not even been introduced. Many of the transfers, particularly the governmental purpose assets (such as recreation centers, libraries, roads and public parking lots), were part of the normal practice of redevelopment agencies under the former Redevelopment Law, where the Agency assisted with the development of public improvements and then transferred such assets to the City. All of the transactions discussed in the Review were in fact legally made, but are now retroactively deemed "unallowable" without consideration of the individual circumstances of the various agencies statewide.

Given the factual circumstances outlined above, the City makes a general objection to the "retroactive" nature of the asset review conducted by the Controller and its authority to order the return of assets. The City does not waive any theories of legal challenge to the legality of this review and proposed orders. Where the Draft Review points out that "the purpose of the asset transfers was to protect redevelopment agency resources from the dissolution of the RDA," the City only answers that there was no "dissolution" at the time of the transfers and, even if true, such transfers were legally made pursuant to the Redevelopment Law still in effect at the time.

In the following comments, the City agrees with the Controller's conclusions in many instances (with the caveat of the general protest). In other instances, these comments point out the circumstances unique to Morgan Hill that would legally justify the transfers even in light of the ABX1 26 and AB 1484 schemes.

Comments Relating to Finding 1 (Transfers to City)

Draft Review Finding 1, 1st bullet, page 4: "In February and March 2011, the RDA transferred capital assets of \$83,207,948 in land and improvements to the City the RDA was not allowed to transfer physical assets or cash to a public agency after January 1, 2011."

Comment: Agree in part. The transfers of capital assets were not unlawful at the time they were made. They were legally documented; and were approved in an open, noticed public meeting. We do agree, however, that the legal transfers of capital assets are subject to retroactive invalidation and, to the extent such transferred assets have not been committed to third parties, they are subject to claw back per ABX1 26. Therefore, the City will return the capital assets to the Successor Agency for subsequent disposition or transfer to the City as directed by the Oversight Board.

Draft Review Finding 1, 2nd bullet, page 4: "On February 24, 2011, the RDA transferred \$2,430,000 in cash to the City for future capital improvements and replacement costs for all building systems and equipment for all RDA capital assets that were transferred the RDA was not allowed to transfer physical assets or cash to a public agency after January 1, 2011.

Comment: The transfers of cash were not unlawful at the time they were made. They were legally documented; and were approved in an open, noticed public meeting. We do agree, however, that the legal transfers of cash are subject to retroactive invalidation and, to the extent such transferred assets have not been committed to third parties, they are subject to claw back per ABX1 26. Of the \$2,430,000 transferred, the amount of \$186,923 was the RDA's obligation for FY 11-12, which has now been discharged. Therefore, the City will return to the Successor Agency all but \$186,923 of the \$2,430,000. The Successor Agency will, in turn, convey the cash to the County Auditor-Controller for disbursement to the underlying taxing jurisdictions as directed by ABX1 26.

Draft Review Finding 1, 3rd bullet, page 4: "On February 24, 2011, the RDA transferred \$2,002,000 in cash to the City for advance payment to prepay the lease ... of space to house the RDA/Successor Agency The City is required to return the entire amount back to the Successor Agency for disposition because the calculation did not reflect the amount of time used by the RDA. The Successor Agency is directed to use its authority ... to revise the lease and calculate the revised annualized lease payments that should have been made the by the RDA ... and which should be made by the Successor Agency Such payments are required to be included on a Recognized Obligations Payment Schedule (ROPS) and approved for payment by the Department of Finance."

Comment: Agree in part. The City agrees that the lease contract is subject to the retroactive invalidation of contracts between the former Agency and the City (H&S §34178(a)). The City disagrees, however, with the Draft Review's direction to "use its (Successor Agency's) authority ... to revise the lease and calculate the revised annualized lease payments that should have been made by the RDA"

While the Controller has the statutory authority to order the return of assets, he is without authority to dictate the nature or amount of enforceable obligations. The Oversight Board (with approval by the Department of Finance) has the authority to approve the re-entering of the lease agreement (H&S §34178(a)). It is also notable that under AB 1484, the Successor Agency has the additional authority to create enforceable obligations to conduct the work of winding down the Redevelopment Agency (H&S §34177.3(b)).

Even if the Controller has some authority to order the revision of the lease payment amount, the suggested method of lease calculation is based on faulty assumptions. The annual lease amount of

\$154,000 is tied to a portion of the annual debt service the City pays to bondholders who financed construction of the office building that the former RDA and, now, the Successor Agency occupies. The building and the bond issue that financed it were sized on the reasonable assumption that the former RDA would be occupying an agreed-upon portion of the building based on what the RDA would need for the purposes of implementing the former RDA's Redevelopment Plan. The disappearance of the RDA does not imply the disappearance of the obligation of the Successor Agency to continue to pay the City for the costs it incurred in paying for the RDA's planned share of the space in the building. It is not unusual in commercial leasing that the tenant is obligated to pay a lease amount and commit to a lease term that would compensate the landlord for the costs of constructing and improving leased space to suit the needs of the tenant. Just because the tenant, during the term of the lease, no longer needs the same space as contemplated at the time of the making of the lease does not obligate the landlord to adjust either the amount or the term of the lease. Neither is it unheard of for the tenant to prepay a lease for years in order to compensate the landlord upfront for the cost of the improvements of the tenant space.

Draft Review Finding 1, 4th bullet, page 5: "On February 24, 2011, the RDA transferred \$977,000 in cash to the City for advance payment for the reconstruction of RDA-owned parking lots. To accomplish this transfer, the City and the RDA entered into an agreement the RDA was not allowed to transfer physical assets or cash to a public agency after January 1, 2011."

Comment: Agree in part. The transfers of land and cash were not unlawful at the time they were made. They were legally documented; and were approved in an open, noticed public meeting. We do agree, however, that the legal transfers of assets are subject to retroactive invalidation and, to the extent such transferred assets have not been committed to third parties, they are subject to claw back per ABX1 26. The City will return the \$977,000 of cash to the Successor Agency and ask the Oversight Board to consider approving a transfer of ownership of the former RDA-owned parking lots to the City.

Draft Review Finding 1, 5th bullet, page 5, 1st sentence: "On March 7, 2011, the RDA transferred \$1,300,000 in cash to the City for an unfunded advance Public Employee Retirement System (PERS) obligation."

Comment: Agree.

Finding, 2nd sentence: "This amount was never budgeted, appropriated, or encumbered by the RDA."

Comment: Disagree. The Redevelopment Agency Board authorized the transfer at its meeting of January 26, 2011, and amended the FY 10-11 RDA budget to reflect the transaction at its meeting of April 20, 2011.

Finding, 3rd sentence: "While the RDA is liable for its actual share of the PERS obligation, there is no accurate documentation calculating the actual amount of this obligation."

Comment: Disagree. City staff provided the State Controller's Office with detailed calculations underlying the \$1.3 million unfunded accrued actuarial liability -- calculations at a level of detail that even CalPERS itself was, and is, incapable of generating. Staff also provided proof to the State Controller's Office auditors that the \$1.3 million had been paid to CalPERS.

Finding, 4th & 5th sentences: "The full amount should be returned to the Successor Agency and the City may re-bill the Successor Agency for the actual amount of costs incurred on behalf of the RDA. The bill is required to be included on a ROPS and approved for payment by the Department of Finance."

Comment: Disagree. The pension payments made to CalPERS (a third party) were made to satisfy pension obligations that had *already* been incurred for the period of the employment of RDA employees prior to the enactment of ABX1 26. So, the order to transfer back and place such obligation on the ROPS is both unsupported by law and impossible to do. First, the Controller has the power to order the transfer back of assets only if the City "is not contractually committed to a third party for the expenditure or encumbrance" (H&S §34167.5). Pension obligations were in fact an incurred obligation to a third party beyond the Controller's power to claw back. Second, nothing in either ABX1 26 or AB 1484 requires the City as Successor Agency to place on a ROPS—years after it has already been incurred and paid—a payment obligation made in good faith prior to the enactment of ABX1 26. Third, it is impossible to return the funds to the Successor Agency, because the City does not have them; CalPERS does. Nothing in the law requires, and in fact it would be unconstitutional to require, the City to pay to the Successor Agency moneys from other funds of the City. Therefore, we respectfully request that your division remove this finding altogether. If you need another copy of the detailed calculations, please ask the City's Finance Director or Assistant Finance Director.

Draft Review Finding 1, 6th bullet, page 5, 1st and 2nd sentences: "On March 7, 2011, the RDA transferred \$391,050 in cash to the City for the purpose of paying Unemployment Insurance claims for RDA staff who were laid off. The City used the highest salary to determine the estimate amount to be paid into the unemployment fund."

Comment: Agree, but please change "salary" to "weekly benefit" in this sentence. Every affected employee earned a high enough salary to qualify for the maximum unemployment benefit under Federal law.

Finding, 3rd sentence: "This amount was never budgeted, appropriated, or encumbered by the RDA."

Comment: Disagree. The Redevelopment Agency Board authorized the transfer at its meeting of January 26, 2011, and amended the FY 10-11 RDA budget to reflect the transaction at its meeting of April 20, 2011.

Draft Review Finding 1, 6th bullet, remaining sentences: "While the RDA is liable for its actual share of Unemployment Insurance claims, there is no documentation calculating the actual amount of this obligation. The full amount should be returned to the Successor Agency and the City may re-bill the Successor Agency for the actual amount of costs incurred on behalf of the RDA. The bill is required to be included on a ROPS and approved for payment by the Department of Finance."

Comment: Agree in part. As you point out at the top of page 2, "By law, the State Controller is required to order that such assets, *except those that already had been committed to a third party prior to June 28, 2011* (effective date of ABX1 26), be returned" (Emphasis added) Obviously, unemployment benefits were committed to both EDD and the laid-off RDA staff prior to June 28. Finally, as noted in the section immediately above, Section 34171(d)(1)(B) defines

unemployment payments as enforceable obligations, similar to pension payments. Indeed, laid-off employees are still collecting unemployment benefits as of this writing, and may continue to do so—up to the maximum of 99 weeks authorized under Federal law. Therefore, the city will return all but the \$31,310 expended on unemployment benefits already received by former RDA staff through March 31, 2012, plus the (not yet known from EDD) amount claimed by those former employees since then. For *future* unemployment claims, the City will take the recommended action and put them on a ROPS for approval.

Comments Relating to Finding 2 (Transfers to the MHEDC)

Draft Review, Finding 2, Entire Finding: In sum, the Finding is that because “it appears the purpose of the transfers was to protect RDA resources from the elimination of the RDA” and because the MHEDC is “an agency described under H&S Code Section 34167.10” that the transfers to the MHEDC are unallowable.

Comment: The MHEDC is a bona fide independent corporation and is NOT a “city” under H&S §34167.10. The motivations of the City Council for creating the MHEDC, which the Draft Report suggests may have included the protection of RDA assets from RDA dissolution, are irrelevant to the analysis of whether the transfer is legal and allowable or whether the transfer is subject to the Controller’s power to “claw back” the assets.

1. The MHEDC is a bona fide corporation and not a “city” or an agency of the City.

It cannot be disputed that the MHEDC is a duly incorporated domestic corporation of the State of California, organized under the Nonprofit Public Benefit Corporation Law for charitable purposes, and specifically for the primary purposes of providing “physical, economic and educational development, redevelopment and revitalization efforts with the City of Morgan Hill . . .” (Articles of Incorporation, MHEDC). Even though it was first created by the City, it is organized and operated as a corporation wholly independent of the City:

- Under its bylaws, as amended at a duly organized meeting of the Corporation on March 7, 2012, the board of directors consist of 5-7 members;
- Only a maximum of 2 members may be sitting members of the City Council (MHEDC Bylaws Section 4.03(b)) and, therefore, the majority of the Board members are always non-City Council members independent of the City’s control;
- The Board holds its meetings at a time and place different and apart from City Council meetings;
- The Board has hired its own legal counsel;
- The Board has obtained insurance covering MHEDC assets; and
- The Board has made the necessary filings with the Internal Revenue Service.

As such, the MHEDC fails to meet the definition of a “city” under H&S §34167.10:

- According to the City’s independent auditor, the MHEDC is not a component unit of the City since March 7, 2012 when its bylaws were amended, for reporting purposes or for the purposes of its comprehensive annual financial report. Therefore, the MHEDC does not meet the definitions of a city under H&S §34167.10(a) (1) or (2).

- MHEDC does not meet the definition of a “city” under H&S §34167.10(a)(3) (“any entity which is controlled by the city . . .”).
 - Other than certain reporting and use requirements regarding the assets transferred to the MHEDC pursuant to then existing Redevelopment Law and an Operating Agreement dated March 8, 2011, the MHEDC board has complete control and discretion over its own assets, operation, revenues and expenditures. Other than the initial seed funding comprised of assets transferred by the RDA, the City is not obligated, and has no intention, to further support or contribute to the MHEDC. The MHEDC has control over its operation, expenditures and revenues. The MHEDC has its own corporate powers to raise its own revenues.
 - All assets of the MHEDC are held in the corporation’s title. The City has no ownership or control over MHEDC assets, including the assets transferred to the MHEDC.
 - The MHEDC has an independent board having no more than 2 City Council members (out of 5-7 board members) and its boundaries are not coterminous with that of the former RDA (the MHEDC covers the entire City of Morgan Hill, which is larger than the former Redevelopment Area).
 - Even though the City did form the MHEDC, the clear intent from the outset of the Corporation was to create an independent corporation.
 - The MHEDC’s purpose is to improve “the physical, economic and educational development, redevelopment and revitalization efforts within the City of Morgan Hill”, which are not the customary functions performed by *municipalities through levies of property taxes*. It should be noted that such functions were some of the functions of the former RDA, but the *RDA was not a “municipality”* (it was an agency of the State) *and had no power to levy property taxes*. The historical and customary functions of the City are public safety, health & welfare and land use.
 - The City provides administrative and business support for the MHEDC *only through an executed agreement for reimbursement of such expenses by the MHEDC to the City*, as a temporary measure until the MHEDC may hire its own staff. The City does not assume the expense of normal daily operations of the MHEDC.

- 2. The MHEDC is not a city and the transfers to it by the RDA under former Redevelopment Law are allowable, even if “it appears that the purpose of the asset transfer was to protect RDA resources from the elimination of the RDA.”

It is well established rule of judicial interpretation that “the possible improper motivations of the Legislature or its members in passing legislation are immaterial to questions involving the validity of such legislation” *County of Los Angeles v. Superior Court*, 13 Cal.3d 721, 728 (1975). Therefore, in looking at whether the transfers from the RDA to the MHEDC were permissible, a court will not delve into the motivations of the former RDA board when it adopted the legislation to transfer assets. It would be irrelevant whether the RDA’s purpose was to “protect RDA resources” as long as the MHEDC is a bona fide corporation to which the RDA could legally transfer assets under the then existing Redevelopment Law.

In *City of Cerritos v. Cerritos Taxpayers Assn.*, 183 Cal.App.4th 1417 (2010), the court of appeal upheld an arrangement in which the Cerritos Redevelopment Agency transferred land and

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August 2, 2012
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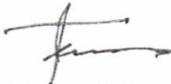
financial assets to a nonprofit corporation formed by the City of Cerritos so that the nonprofit corporation could develop low and moderate income housing. In that case, the Cerritos Taxpayers Assn contended that the City created the nonprofit corporation only to escape the requirement under Article XXXIV, §1 of the California Constitution that a majority of voters must approve the construction of low income housing by *any state public body*. The association contended that the nonprofit organization was merely a “shell corporation” controlled by the City and Agency intended to skirt the voter approval requirement of *public agency* housing projects. The court observed that the nonprofit board members were the same members as the city council, though the city intended to transition into a permanent board of members of the public. Even with such observation, the court held that the corporation is a private corporation and the housing project it will construct is “privately owned” and not subject to the voter requirement of a public housing project. The court held:

“We are not at liberty to ignore the corporation's status; it has a “genuine separate existence” from the City and Agency, so “it does not matter whether or not the City ‘essentially controls’ Cuesta Villas [the nonprofit organization]. . . . The City and Agency have avoided the voter approval requirement of Article XXXIV, but the law permits what has been done.”

So here, the Controller cannot simply ignore the separate existence of the MHEDC from the City, whether under corporate law or under the tests of H&S §34167.10(a). Even if the purpose of creating the MHEDC was to protect RDA assets, the law (at the time that the EDC was formed) permitted what has been done. Based on both H&S§34167.10(a) and on case law, the Controller cannot order the City to “direct the MHEDC to reverse the transfer” of assets when the City has no control over the independent decision of the MHEDC, a bona fide nonprofit corporation.

Again, thank you for the opportunity to comment on your draft report. We specifically ask you to withdraw or modify specified findings as described above. We would appreciate an opportunity to review and comment upon your subsequent draft. If no changes are made, we request that these comments be included, in their entirety, in the final report.

Sincerely,



J. Edward Tewes
City Manager

c: Betty Moya, Audit Manager
Moises Laurel, Audit Manager

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