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REPORT TO HONORABLE MAYOR AND CITY COUNCIL MEMBERS

RISKS ASSOCIATED WITH PROPOSED OPERATING AND MANAGEMENT
AGREEMENT FOR RENEWED DOWNTOWN PROPERTY AND BUSINESS
IMPROVEMENT DISTRICT

INTRODUCTION

The existing Downtown Property and Business Improvement District (Downtown PBID), administered by the Downtown San Diego Partnership (Partnership), will expire on June 30, 2015. On May 11, 2015, the City Council will receive public testimony and deliberate on the renewal of the Downtown PBID, before the City Clerk tabulates the ballots submitted by affected property owners. If no majority protest exists, the City Council is expected to vote on the proposed Resolution of Formation on May 12, 2015.

The City Council also will be asked to approve an Operating and Management Agreement (Operating Agreement) between the City and the Downtown San Diego Partnership (Partnership). The Operating Agreement is contemplated by the District Plan and has been prepared in accordance with the Property and Business Improvement District Law of 1994, California Streets and Highways Code sections 36600-36671 (PBID Law). Pursuant to the Operating Agreement, the Partnership will serve as the owners' association for the Downtown PBID (Owners' Association) and will administer and implement improvements, maintenance, and activities specified in the District Plan (District Services). Generally, District Services will consist of an enhanced level of services provided for the benefit of property owners in the Downtown PBID and financed through annual assessments paid by those property owners, in excess of the baseline services normally provided and paid for by the City.

Over the past several months, this Office has coordinated extensively with City staff negotiating the Operating Agreement. The arms'-length negotiations between the City and the Partnership have produced mixed results in terms of protecting the City's interests. Some negotiated changes to the Operating Agreement will substantially increase the City's risk with regard to the Partnership's provision of District Services. The Partnership's activities pursuant to the District Plan and the Operating Agreement, if approved based on their current content, may expose the City to significant legal and financial risks that are difficult to quantify at this time. In this Office's view, the Operating Agreement deviates too far from the City's standard language for management agreements involving assessment districts and thus does not adequately protect the City's interests in several respects. Moreover, the negotiated changes to the City's standard

contractual language in this instance could severely undercut the City's bargaining power during the negotiation of similar management agreements for various other assessment districts throughout the City.

For the above reasons, this Office recommends that the City Council either reject the Operating Agreement in its current form or direct City staff to renegotiate with the Partnership regarding certain non-standard contractual provisions. In addition, if a third party consultant has not executed a certain reimbursement agreement (presently still under negotiation) containing adequate defense and indemnity provisions in the City's favor, this Office recommends that the City Council either postpone the approval of the District Plan or modify the District Plan to ensure that the City ultimately gains the benefit of those defense and indemnity provisions. This report explains the basis for both of these recommendations in detail.

QUESTION PRESENTED

What risks to the City could result if the Operating Agreement is approved in its current form?

SHORT ANSWER

Approval of the Operating Agreement in its current form could give rise to several potential risks to the City. The most prominent risks include: (a) an increase in the City's potential liability, due to non-standard defense and indemnity provisions that are more advantageous to the Partnership than the City's standard contractual provisions; (b) the City's limited ability to terminate the Operating Agreement in the event of problems, short of the Partnership's malfeasance or misappropriation of funds; and (c) an increase in exposure to the City's General Fund, due to a reduced retention amount for annual assessment funds.

ANALYSIS

The Operating Agreement represents the culmination of extensive negotiations between the City and the Partnership over the past year. As is typical for a heavily negotiated document, the Operating Agreement contains some provisions that benefit the City and other provisions that may expose the City to various risks. The discussion below is not an exhaustive explanation of all potential risks, but instead briefly highlights what this Office considers the most prominent risks related to the Operating Agreement, a related three-party agreement with the Partnership and the project engineer, and another three-party agreement that is presently still under negotiation with the Partnership and the project consultant. In addition, this Office has addressed other matters related to the Operating Agreement in a confidential memorandum that will be distributed concurrently with this public report.

I. THE CITY WILL NOT HAVE THE BENEFIT OF STANDARD DEFENSE AND INDEMNITY PROVISIONS IN ITS FAVOR

A. Formation Liability

The City is not fully protected against potential liability resulting from a challenge to renewal of the Downtown PBID. The City has previously entered into agreements with engineers related to the formation of other assessment districts, wherein the engineers provided all services associated with district formation and fully defended and indemnified the City against a legal challenge to district formation.¹ In the case of the Downtown PBID, the formation-related services are divided between Bennett Engineering Services, Inc. (Engineer) and Civitas Advisors, Inc. (Consultant). Pursuant to the existing agreement among the City, the Engineer, and the Partnership (Three-Party Agreement), the Engineer is obligated only to indemnify the City and the Partnership, and not to defend against legal actions associated with the Engineer's scope of services under the Three-Party Agreement. As discussed further below, the City has no contractual relationship with the Consultant. As a result, if renewal of the Downtown PBID is challenged, the City will have to incur the legal defense costs and seek reimbursement from the Engineer to the extent that Engineer is found responsible. The City would have no contractual recourse against the Consultant for any of its services or work product that may have contributed to invalidation of the Downtown PBID.

Pursuant to the District Plan, the cost of renewing the Downtown PBID can be repaid using assessment funds in an amount not to exceed \$250,000. Also pursuant to the District Plan, this repayment shall be "in accordance with the reimbursement agreement between the City of San Diego and the Partnership" (Reimbursement Agreement). The actual cost of renewing the Downtown PBID consists of services from two parties, namely the Engineer and the Consultant. As noted above, the existing Three-Party Agreement requires the Engineer to indemnify, but not defend, the City in an action challenging renewal of the Downtown PBID. The City is currently negotiating the Reimbursement Agreement to include the Consultant as a party and to require that the Consultant provide the City with an acceptable level of defense and indemnity against a legal challenge to renewal of the Downtown PBID. If the final version of the Reimbursement Agreement does not require the Consultant to defend and indemnify the City with respect to the Consultant's portion of the renewal services, then no third party would be responsible for the City's defense of a legal action, and the City could only pursue the Engineer for indemnity as it relates to the Engineer's limited scope of services. To the extent the Consultant has conducted any renewal work, the City would have no contractual recourse against the Consultant.

Given that the District Plan governs the expenditure of assessment funds, and given that the City Council may modify the District Plan within certain parameters, the City Council could

¹ The City has, in the past, relied on the engineer responsible for drafting the engineer's report to cover any loss or liability resulting from a legal challenge to the formation of an assessment district, including dissolution of a district (e.g., the Greater Golden Hill Maintenance Assessment District). Pursuant to PBID Law, the engineer's report must be included in the District Plan, must support all assessments contemplated by the District Plan, and must be prepared by a registered professional engineer certified by the State of California. Cal. Sts. & Hwy. Code § 36622.

amend language in the District Plan to require that the parties who have provided renewal services, particularly the Consultant, will bear some level of responsibility related to those services. This Office recommends that the City Council either postpone the approval of the District Plan to allow more time for the parties to complete negotiations on the Reimbursement Agreement or modify the District Plan to require adequate defense and indemnity provisions in the City's favor in the event that the Reimbursement Agreement has not been executed before the City Council adopts the Resolution of Formation. If the Reimbursement Agreement is not executed before the Resolution of Formation is adopted, the City will lose significant bargaining power relative to the Consultant in final negotiations of the Reimbursement Agreement.

B. Operations Liability

The Operating Agreement contains insurance and indemnity provisions that offer significantly less protection for the City in comparison to other management agreements that the City has negotiated in recent years with other nonprofit entities that manage assessment funds for districts throughout the City and other contractors providing similar services. This Office's proposed final draft of the Operating Agreement included comprehensive insurance provisions relatively consistent with the City's standard template. The Partnership modified or deleted some of these provisions, however, on May 5, 2015, immediately before City management needed to decide whether to post the Operating Agreement in the City Council's agenda materials. Based on preliminary input from the Risk Management Department, City management decided to accede to the Partnership's changes in the standard contractual provisions.

General Liability. The City would typically require a contractor to maintain insurance coverage that protects the City under an additional insured endorsement for liability arising out of (a) ongoing operations performed by or on the contractor's behalf, (b) the contractor's products, (c) the contractor's work, including, but not limited to, completed operations performed by or on behalf of the contractor, and (d) any premises owned, leased, controlled or used by the contractor. This City's typically broad language on a contractor's obligation to provide an additional insured endorsement in the City's favor has been removed from the Operating Agreement. Section 8(E)(1) of the Operating Agreement contains a very brief description of additional insured coverage that is arguably much narrower than the City's standard language. Under one plausible interpretation of Section 8(E)(1), the Partnership could fulfill its obligations under the Operating Agreement even if it provides additional insured coverage to the City for only one out of the four categories identified in clauses (a) through (d) above. Indeed, this Office is informed that the Partnership intends to obtain only additional insured coverage for ongoing operations as described in clause (a) above. While ongoing operations coverage is arguably the most important out of the four typical categories, the inclusion of that category alone in the additional insured endorsement will provide the City with less insurance protection than the normal management agreement for assessment districts. Further, any subcontractor performing work pursuant to the Operating Agreement would be able to limit the City's additional insured coverage in the same manner. As a result, the City could incur substantial liability for claims arising from acts or omissions of the Partnership or its

subcontractors in managing the Downtown PBID and constructing public improvements, without the ability to tender those claims to the Partnership's or subcontractors' insurers.

Sidewalk Liability. Under the existing operating agreement that governs the Partnership's management of the current Downtown PBID and will expire on June 30, 2015 (Existing Operating Agreement), the Partnership must provide notice to the City of any existing safety hazards throughout the Downtown PBID, and is subject to liability for failing to do so. Yet, the Section 4(D)(1) of the proposed Operating Agreement requires only that the Partnership make "reasonable efforts" to provide notice to the City. This standard is much more favorable to the Partnership. In the event of any future injury or loss associated with sidewalks in the Downtown PBID, the Partnership will have a much higher chance of meeting the reasonable efforts standard, thereby allowing the Partnership to avoid any liability. Further, the City has agreed to hold the Partnership responsible for third party claims or losses related to hazardous conditions only if the Partnership, its employees, or agents have (i) provided work causing the hazardous condition to occur, (ii) accepted responsibility for the maintenance, repair, or safety of the particular improvement causing the hazardous condition on public property, or (iii) notified the City regarding their intent to address the hazardous condition. Finally, to the extent that the Partnership's agents, including subcontractors, provided work causing the hazardous condition to occur, the City might have inadequate or no additional insured coverage for the third party loss as a result of the limited insurance requirements in the Operating Agreement.

Mutual Indemnity. The City typically requires that a contractor agree to defend and indemnify the City from and against all claims, expenses, and liabilities related directly or indirectly to the performance of services under the contract by the contractor or its agents. Under the City's standard template, the City does not agree to defend or indemnify a contractor; in other words, there is no mutual indemnity provision. By contrast, the Existing Operating Agreement requires the City and the Partnership to indemnify each other for their respective negligence or failure to perform services or other obligations under the Existing Operating Agreement. Section 7 of the Operating Agreement contains a similar mutual indemnity provision, although this provision is less protective for the City in comparison to the Existing Operating Agreement. As discussed above, the Operating Agreement reduces the Partnership's obligation with respect to notice of, and liability for, hazardous conditions, as well as its obligation with respect to providing additional insured coverage. In addition, as a nonprofit corporation reliant upon the Downtown PBID for its ongoing income, the Partnership may not have the financial wherewithal to pay any significant indemnity claim to the City.

II. THE CITY WILL NOT HAVE THE BENEFIT OF THE STANDARD CLAUSE ALLOWING TERMINATION OF THE OPERATING AGREEMENT

The City's standard agreement with third party contractors gives the City broad authority to terminate the agreement for numerous reasons. For instance, the Existing Operating Agreement authorizes the City to terminate the agreement if the City Council determines, after holding a public hearing on the matter, that termination is in the best interest of the Downtown PBID. The proposed Operating Agreement does not include the City's standard termination

provisions. Instead, Section 9 of the Operating Agreement allows the City to terminate the agreement only if the City Council determines, after holding a public hearing, that the Partnership has committed malfeasance or misappropriation of Downtown PBID funds. By contrast, the Partnership may terminate the Operating Agreement at any time upon advance written notice of 90 calendar days.

III. UNDER THE DISTRICT PLAN, THE CITY'S HISTORICAL RETENTION AMOUNT OF ASSESSMENT FUNDS WILL BE REDUCED FROM FIVE TO THREE PERCENT, EXPOSING THE CITY'S GENERAL FUND TO ADDITIONAL RISK

The Existing Operating Agreement allows the City to retain as a contingency, and thus withhold from the Partnership temporarily, five percent of the annual assessments to establish a prudent fiscal reserve. Pursuant to the District Plan, the City is only authorized to retain three percent of the assessments collected annually, and the proposed Operating Agreement is subject to this requirement. Through the Operating Agreement, the City has a limited ability to control the rate at which this retention will be released to the Partnership at the end of each fiscal year. Pursuant to Section 5(C) of the Operating Agreement, the City may continue to withhold a portion of the three percent retention at the end of each fiscal year, depending on the average rate of delinquent assessments in the three previous years. Although Section 5(C) provides some protection to the City in the event of delinquent and unpaid assessments, the Downtown PIBD will remain dependent on the City's working capital advances. The decrease in the retention amount from five to three percent will impose additional risk on the City's General Fund, which will finance District Services temporarily each year during the period from July through approximately January until the City receives approximately half of the annual assessment funds from the San Diego County Auditor-Controller as part of the property tax collection process.

CONCLUSION

Approval of the Operating Agreement in its current form could give rise to several potential risks to the City. The most prominent risks include: (a) an increase in the City's potential liability, due to non-standard defense and indemnity provisions that are more advantageous to the Partnership than the City's standard contractual provisions; (b) the City's limited ability to terminate the Operating Agreement in the event of problems, short of the Partnership's malfeasance or misappropriation of funds; and (c) an increase in exposure to the City's General Fund, due to a reduced retention amount for annual assessment funds.

In this Office's view, the proposed Operating Agreement does not adequately protect the City's interests, particularly in comparison to the Existing Operating Agreement for the Downtown PBID and the City's standard template for contracts involving the administration of other assessment districts throughout the City. In an effort to gain adequate protection for the City, this Office is making two recommendations to the City Council. First, the City Council should either reject the Operating Agreement in its current form or direct City staff to renegotiate with the Partnership regarding certain non-standard contractual provisions described in this report. Second, if the Reimbursement Agreement (presently still under negotiation) is not timely

executed in a form that contains adequate defense and indemnity provisions in the City's favor, the City Council should either postpone the approval of the District Plan or modify the District Plan to ensure that the City gains the benefit of those defense and indemnity provisions.

This Office is available to assist in drafting any modified language for the Operating Agreement, the Reimbursement Agreement, and the District Plan that the City Council may deem necessary in response to the legal advice contained in this report.

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By /s/ Daphne Z. Skogen
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DZS:dkr

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