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MEMORANDUM OF LAW

DATE: May 13, 2005

TO: Madison Wiggins, Supervising Property Agent, Real Estate Assets
Department

FROM: City Attorney

SUBJECT: Lease and Potential Sale of Sikes Adobe Property

INTRODUCTION

The Real Estate Assets Department [READ] is currently negotiating with the San Dieguito River Valley Regional Open Space Park Joint Powers Authority [JPA] for the lease and/or potential sale of the Sikes Adobe and the surrounding 5-acre site [Sikes Property]. The JPA has questioned whether it must pay fair market value for the lease and/or purchase of the Sikes Property.

QUESTION PRESENTED

Must the JPA must pay the City fair market value for the lease and/or purchase of the Sikes Property?

SHORT ANSWER

Yes. Because the Sikes Property was purchased for water utilities purposes, its disposition is subject to Charter section 53 and bond covenant restrictions. Charter section 53 requires that any lease or sale of water utilities property be at fair market value. In addition, current bond covenants require, among other things, the payment of fair market value for the lease or purchase of the Sikes Property if it is material to the operation of the City's water system.

BACKGROUND

The JPA was formed in 1989 in accordance with a joint exercise of powers agreement between the City of San Diego, the County of San Diego, and the cities of Del Mar, Escondido, Poway, and Solana Beach [JPA Agreement]. San Diego Resolution No. 273718; San Diego Document No. RR-273718. Under the terms of the JPA Agreement, (June 12, 1989) the JPA was formed as a public entity separate from the parties to the JPA Agreement. JPA Agreement § 3; Cal. Gov't Code § 6507. The purpose of the JPA is to acquire, plan, design, improve, manage, operate, and maintain the San Dieguito River Valley Regional Open Space Park [Park]. JPA Agreement § 1.

The Sikes Property was acquired by the City for water utilities purposes as part of the acquisition of the Lake Hodges Reservoir. *See* Attachment A, Property Department Land Acquisition Record. The Lake Hodges Reservoir is part of the City's water system. The Sikes Property is located in the San Pasqual Valley and is within the boundaries of the Park. *See* Attachment B, Acquisition Map for Hodges Reservoir, and Attachment C, San Dieguito River Park Focused Planning Area. The JPA desires to lease and/or purchase the Sikes Property for use as an interpretive historical site and eventually as a visitor's center for the Park.

ANALYSIS

There are two primary documents that control the use and disposition of revenues and property acquired for water utilities purposes. The principal document is the San Diego Charter [Charter], which is essentially the City's constitution. *See Domar Electric, Inc. v. City of Los Angeles*, 9 Cal. 4th 161, 170 (1994). The second is a financing agreement entered into by the City in order to improve its water system infrastructure.

A. The Charter Requires the Sikes Property to be Leased or Sold at Fair Market Value.

Historically, the Charter has reflected a serious concern that the provision of water and water services to City residents is of primary importance. 1980 Op. City Att'y 69, 70. The Charter contains rather unique provisions designed to guarantee, to the extent possible, the availability of funds for water and water utility services. *Id.* Thus, although the City's Water Department is an administrative branch of the City, it is considered to be a "separate utility." San Diego Charter § 53. As such, all revenues of the Water Department must be deposited in a Water Utility Fund and used for Water Department purposes. *Id.*

Although Charter section 53 does not specifically address the lease or sale of property acquired for water utility purposes [Water Property], this office has consistently opined that Section 53 requires any lease or sale of Water Property to be at fair market value. *See* Attachment D, 1980 Op. City Att'y 83, and Attachment E, 1992 City Att'y MOL 493. Fair market value must be obtained even if the City was to transfer "ownership" of real property from the Water Department to another City department. *See* Attachment F, Memorandum from City

Attorney to Council District 2 (August 14, 1989) (discussing court holding that City must receive fair market value for exchange of water utility property with general fund property).

Thus, if Water Property is to be leased or sold to any non-Water Department entity, the City must obtain fair market value for that lease or sale. As such, despite the fact that the City is a member of the JPA, the Charter requires the City to lease or sell the Sikes Property to the JPA at fair market value.¹

B. The MIPA Requires Payment of Fair Market Value for the Lease or Sale of Water Property.

In addition to the Charter restrictions, the disposition of the Sikes Property is restricted by bond covenants. In order to enable the City to continue improving its water system, the City and the San Diego Facilities and Equipment Leasing Corporation [Corporation] entered into a Master Installment Purchase Agreement dated August 1, 1998 [MIPA].² In addition to restricting the use of Water Department revenues in a manner consistent with the Charter, the MIPA restricts the disposition of Water Property (both real and personal). Specifically, the MIPA provides:

(a) The City will not sell, lease or otherwise dispose of the Water System or any part thereof essential to the proper operation of the Water System or to the maintenance of the System Revenues, except as provided in Sections 6.04(b) and Section 6.19 hereof.³ Further, the City will not, except as otherwise provided herein, enter into any agreement or lease which impairs the operation of the Water System or any part thereof necessary to secure adequate Net System Revenues for the payment of the Parity Obligations or which would otherwise impair the rights of

¹See also Council Policy 700-14 (payment of fair market value required for lease or sale of property held in trust for water utilities purposes that is located within the planning area of the San Dieguito River Park).

²The MIPA was entered into as the means of providing for the acquisition of Water Department capital improvements financed by \$385 million of certificates of participation. The terms and conditions of the MIPA control with respect to all bonds and securities secured by revenues of the Water Utility Fund, including the water revenue bonds issued in 2002 by the Public Facilities Financing Authority of the City of San Diego.

³The term "Water System" includes all properties owned by the City as part of the public utility system of the City for water purposes. MIPA § 1.01. (Section 6.19 of the MIPA authorizes the City to delegate the power to operate some or all of the Water System, but requires an opinion of Bond Counsel concluding that the delegation will not adversely affect the tax exempt status of interest earned on the bonds).

the Corporation with respect to the System Revenues or the operation of the Water System.⁴

(b) The City may dispose of any of the works, plant properties, facilities or other parts of the Water System, or any real or personal property comprising a part of the Water System, only upon the approval of the City Council and consistent with one or more of the following:

(1) the City in its discretion may carry out such a disposition if the facilities or property being disposed of are not material to the operation of the Water System, or shall have become unserviceable, inadequate, obsolete or unfit to be used in the operation of the Water System or are no longer necessary, material or useful to the operation of the Water System, and if such disposition will not materially reduce the Net System Revenues and if the proceeds of such disposition are deposited in the Water Utility Fund;

(2) the City in its discretion may carry out such a disposition *if the City receives from the acquiror an amount equal to the fair market value of the portion of the Water System disposed of.* As used in this subparagraph (2), “fair market value” means the most probable price that the portion being disposed of should bring in a competitive and open market under all conditions requisite to a fair sale, the willing buyer and willing seller each acting prudently and knowledgeably and assuming that the price is not affected by coercion or undue stimulus. The proceeds of the disposition shall be used (A) to promptly redeem, or irrevocably set aside for the redemption of, Parity Obligations, and/or (B) to provide for a part of the cost of additions to and betterments and extensions of the Water System; provided, however, that before any such disposition under this subparagraph (2), the City must obtain (i) a certificate of an Independent Engineer to the effect that upon such disposition and the use of the

⁴The term Net System Revenues means the System Revenues less the maintenance and operation costs of the Water System for a fiscal year. MIPA §1.01. The term System Revenues includes all rents and proceeds derived by the City directly or indirectly from the lease of a part of the Water System. *Id.*

proceeds of the disposition as proposed by the City, the remaining portion of the Water System will retain its operational integrity and the Net System Revenues will be at least equal to 1.20 times the Adjusted Debt Service on all Outstanding Parity Obligations during the five fiscal years following the Fiscal Year in which the disposition is to occur, taking into account (aa) the reduction in revenue resulting from the disposition, (bb) the use of any proceeds of the disposition for the redemption of Parity Obligations, (cc) the Independent Engineer's estimate of revenue from customers anticipated to be served by any additions to and betterments and extensions of the Water System financed in part by the proceeds of the disposition, and (dd) any other adjustment permitted in the preparation of a certificate under Section 5.03(c)(2)(B) of this Installment Purchase Agreement, and (ii) confirmation from the Rating Agencies to the effect that the rating then in effect on any Outstanding Parity Obligations will not be reduced or withdrawn upon such disposition.

(c) The City will operate the Water System in an efficient and economical manner, provided that the City may remove from service on a temporary or permanent basis such part or parts of the Water System as the City shall determine, so long as (a) Net System Revenues are equal to 120% of Adjusted Debt Service for the then current Fiscal Year, after giving effect to any defeasance of Parity Obligations occurring incident to such removal, and for each Fiscal Year thereafter to and including the Fiscal Year during which the last Installment Payment is due, after giving effect to such defeasance, as evidenced by (1) an Engineer's Report on file with the City, or (2) a Certificate of the City, if the value of the parts of the Water System to be so removed, as shown in the most recently published financial statements of the Water Utility Fund for which there is an accountant's report, is less than 5% of the total Water System Plant assets, as shown on such financial statements, and (b) the City shall have filed with the Trustee an opinion of Bond Counsel to the effect that the removal of such part or parts of the Water System will not adversely affect the exclusion from gross income for federal income tax purposes of the interest on Tax-Exempt Installment Payment Obligations.

MIPA § 6.04 (emphasis added).

Thus, subject to approval of the City Council, the MIPA allows the City to lease or sell Water Property if the lease or sale complies with subsection (b)(1) or (b)(2).⁵ For example, the City may lease or sell Water Property if: (i) the property is not material to the operation of the Water System; (ii) the lease or sale will not materially reduce the Net System Revenues; and (iii) the proceeds from the lease or sale are deposited in the Water Utility Fund. The City may also lease or sell Water Property if the City receives: (i) fair market value for the property; (ii) an Independent Engineer's certificate making certain findings with respect to operational integrity and Net System Revenues; and (iii) a rating confirmation.⁶

Although Section 6.04(b)(1) appears to allow a lease or sale at less than fair market value if the Sikes Property is not material and provided the other enumerated conditions are met, Charter section 53 would nevertheless require payment of fair market value.⁷ On the other hand, regardless of the materiality of the Sikes Property to the Water System's operation, Section 6.04(b)(2) requires the payment of fair market value as well as an Independent Engineer's certificate and rating confirmation.⁸

Further, if the City removes a part of the Water System from service, the City must comply with the conditions in Section 6.04(c). These conditions do not appear to apply when a lease or sale is involved because the subsection (b) provisions specific to leases and sales should control over the subsection (c) provisions generally addressing removal from service.⁹ If, however, subsection (c) does apply to a lease or sale, in addition to the subsection (b) requirements, the City must also obtain an Engineer's Report or a Certificate of the City with respect to Net System Revenues, and file an opinion of Bond Counsel that the removal will not adversely affect the tax-exempt status of the interest on the Water Revenue Bonds.

⁵ The MIPA impliedly defines "dispose" as including leases and sales. *See* MIPA § 6.04(a) ("The City will not sell, lease or *otherwise dispose of* the Water System or any part thereof") (emphasis added). This definition is consistent with the water revenue bond provisions of the Charter which authorize a "prohibition against or limitations upon *the sale, lease or other disposition* or transfer of the waterworks of the City..." San Diego Charter § 90.1(6)(i) (emphasis added).

⁶We note that the MIPA makes no exceptions to the lease or sale restrictions. Thus, in our opinion the City must abide by the covenants regardless of the nature of the entity desiring to lease or purchase Water Property.

⁷Even if the Charter did not require the payment of fair market value, the MIPA would require at a minimum an economically reasonable price that does not materially reduce the Net System Revenues. *See* MIPA §§ 6.04(b)(1); 6.07 (covenant to operate the Water System in an efficient and economical manner); and 6.15 (covenant prohibiting free use of Water System).

⁸The City's bond counsel has indicated that any City Council approval of a lease or sale under subsection (b)(1) must determine that the conditions of that subsection have been met. In our opinion, the determinations could be established by including all relevant supporting information in the backup material provided to the Council.

⁹ We have inquired with bond counsel on this point but have not yet received the response.

CONCLUSION

The Sikes Property is Water Property and is part of the City's Water System. As such, any sale or lease of the Sikes Property must comply with both Charter section 53 and the MIPA. Section 53 requires that any lease or sale of Water Property be at fair market value.

Under the MIPA, if the Water Property is not material to the operation of the Water System, the City could lease or sell the Water Property for an economically reasonable price if all of the other enumerated conditions are met. The Charter section 53 restriction, however, would nevertheless require the reasonable price to be fair market value. On the other hand, regardless of the materiality of the property to the Water System, under the MIPA the City could lease or sell the Water Property for fair market value if all of the other enumerated conditions are met. Finally, if the service removal provisions apply, the City would have to comply with the additional enumerated conditions.

Based on the above, if the City desires to lease or sell the Sikes Property to the JPA, the City must obtain fair market value for the property. The City must also comply with the applicable additional MIPA conditions.⁰⁰

MICHAEL J. AGUIRRE, City Attorney

By

Lori W. Girard
Deputy City Attorney

LWG:cla

Attachments

cc: Charles Yackly, Assistant Director, Water Department
Jack Farris, Deputy Director, Real Estate Assets Department

ML-2005-10

⁰⁰Upon request, we would be happy to address whether a specific proposal would comply with the Charter and MIPA restrictions.