

WEST COVINA COMMUNITY DEVELOPMENT COMMISSION

ASSET TRANSFER REVIEW

Review Report

January 1, 2011, through January 31, 2012



JOHN CHIANG
California State Controller

December 2013



JOHN CHIANG
California State Controller

December 11, 2013

Christopher J. Chung, City Manager
City Of West Covina/Successor Agency
1444 West Garvey Avenue
West Covina, CA 91790

Dear Mr. Chung:

Pursuant to Health and Safety Code section 34167.5, the State Controller's Office reviewed all asset transfers made by the West Covina Community Development Commission to the City of West Covina or any other public agency after January 1, 2011. This statutory provision states, "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 included an assessment of whether each asset transfer was allowable and whether it should be turned over to the Successor Agency.

Our 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 rights to payment of any kind. We also reviewed and determined whether any unallowable transfers of assets to the City of West Covina or any other public agencies have been reversed.

Our review found that the West Covina Community Development Commission transferred \$132,095,288 in assets after January 1, 2011, including unallowable transfers of assets totaling \$8,497,720, or 6.43% of the transferred assets. Those assets must be turned over to the Successor Agency.

If you have any questions, please contact Elizabeth Gonzalez, Bureau Chief, Local Government Compliance Bureau, by phone at (916) 324-0622.

Sincerely,

Original signed by

JEFFREY V. BROWNFIELD, CPA
Chief, Division of Audits

JVB/nh

Attachment

cc: Mike Lee, Assistant City Manager/Community Development Commission Director
City of West Covina
Nita McKay, Director of Finance and Administrative Services
City of West Covina
Denise Bates, Accounting Manager
City of West Covina
Carrie Sutkin, Oversight Board Chairperson
West Covina Community Development Commission Successor Agency
Wendy L. Watanabe, Auditor-Controller
Los Angeles County
David Botelho, Program Budget Manager
California Department of Finance
Richard J. Chivaro, Chief Legal Counsel
State Controller's Office
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Division of Audits, State Controller's Office
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Division of Audits, 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 Community Development Commission of West Covina (RDA) after January 1, 2011. Our review included, but was not limited to, real and personal property, cash funds, accounts receivable, deeds of trust and mortgages, contract rights, and rights to payments of any kind from any source.

Our review found that the West Covina Community Development Commission transferred \$132,095,288 in assets after January 1, 2011, including unallowable transfers of assets totaling \$8,497,720, or 6.43% of the transferred assets. Those assets must be turned over 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.

ABX1 26 was 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," and the date on which the RDA ceases to operate, or January 31, 2012, whichever is earlier.

The SCO has identified transfers of assets that occurred after January 1, 2011, between the RDA, the City of West Covina, and/or other public agencies. By law, the SCO is required to order that such assets, except those that already had been committed to a third party prior to June 28, 2011, the effective date of ABX1 26, be turned over 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 of West Covina, the RDA, and the Successor Agency.
- 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.).

Conclusion

Our review found that the West Covina Community Development Commission transferred \$132,095,288 in assets after January 1, 2011, including unallowable transfers of assets totaling \$8,497,720, or 6.43% of the transferred assets. Those assets must be turned over to the Successor Agency.

Details of our finding is in the Finding and Order of the Controller section of this report.

Views of Responsible Officials

We issued a draft review report on September 30, 2013. Nita McKay, Director of Finance and Administrative Services, responded by letter dated October 9, 2013, disagreeing with the review results. The Successor Agency's and 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 Successor Agency, the City of West Covina, the 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 when issued final.

Original signed by

JEFFREY V. BROWNFIELD, CPA
Chief, Division of Audits

December 11, 2013

Finding and Order of the Controller

**FINDING—
Unallowable asset
transfers to the
City of West
Covina**

The West Covina Community Development Commission (RDA) made unallowable transfers of \$8,497,720 to the City of West Covina (City) after January 1, 2011, which were not contractually committed to a third party prior to June 28, 2011.

Unallowable asset transfers were as follows:

1. The RDA and the City entered into a financing agreement dated May 2, 2000, per Resolution No. 551, establishing a \$5.6 million line of credit to benefit the Citywide Project Area and the Merged Project Area. Our review found that the RDA made unallowable principal and interest payments (asset transfers) in the amount of \$5,973,528 between January 31, 2011, and January 31, 2012.
2. The RDA and the City entered into a financing agreement per Resolution No. 2010-35, establishing a \$2 million loan; and a second agreement per Resolution No. 2010-36, establishing a \$500,000 loan. Per financing agreements dated June 15, 2010, these loans were to fund project and administrative expenses for the West Covina Merged Redevelopment Project Area and the Citywide Project Area, respectively. Our review found that the RDA made unallowable principal and interest payments (transfers) in the amount of \$2,524,192 between January 31, 2011, and March 10, 2011.

Pursuant to Health and Safety (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, that were not contractually committed to a third party prior to June 28, 2011.

Order of the Controller

Based on H&S Code section 34167.5, the City of West Covina is ordered to reverse the asset transfers described above and in Schedule 1, in the amount of \$8,497,720, and turn them over 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).

City and Successor Agency's Response to Draft Report

(Attachment 1 is a copy of the City and Successor Agency's response).

The City acknowledged that during the applicable review period, \$5.9 million was transferred by the RDA to the City in repayment for amounts borrowed under the financing agreement approved by Resolution No. 551 ("Financing Agreement"), and \$2.5 million was transferred by the RDA to the City in repayment for amounts it borrowed under the loan agreements established by Resolutions Nos. 2010-35 and 2010-36 ("Cash Flow Loan"). However, the City disagreed with SCO's draft

Finding 1, stating that the challenged payments between the RDA and the City totaling \$8,497,720 under these agreements were lawful when made.

The City also disagreed with the SCO's determination that the City was not contractually committed to a third party for the expenditure or encumbrance of the challenged transfers. It stated that the City's 2013-2014 fiscal year budget was developed in justified reliance on the retention of the value of the challenged payments, and such funds were assumed by the City in making its budgetary and financial commitments, including those to public health and safety service providers, employee salaries, and City contractors. See the City and Successor Agency's comments in paragraphs 2, 3, and 8 of its response to Finding 1.

In its response, the City also stated that:

- The SCO's draft findings are the subject of a pending lawsuit to which the SCO is a named defendant: *West Covina Successor Agency, et al. v. Matosantos, et al.* (Sac. Sup. Ct. Case No. 2013-80001479).
- The payments made under the Financing Agreement and Cash Flow Loan were enforceable obligations, citing H&S Code section 34167(d), California's Community Redevelopment Law ("CRL"), and stating that both agreements and challenged payments were on the RDA's approved EOPS.
- The SCO's finding/order exceed its authority under H&S Code 34167.5 and stated the SCO's order to reverse the Challenged Transfers violates state law in various respects, including AB1x26 and the California Constitution, and requested that the finding be revised to state that the Challenged Payments were lawful when made. See the City and Successor Agency's comments in paragraphs 1, 4, 5, and 7 of its response to Finding 1.

SCO's Comment

We agree that the cash was transferred by the RDA to the City as repayment for amounts borrowed under both the "Financing Agreement" and the "Cash Flow Loan." However, H&S Code section 34167.5 allows such assets to be retained by the City if they have been "contractually committed to a third party for the expenditure or encumbrance of those assets." The last date by which such contractual commitments must be in place is June 28, 2011. The SCO acknowledges that the City had developed the 2013-2014 fiscal year budget to justify the challenged transfers. However, it did not contractually commit these funds until after this date. H&S Code section 34167.5 also 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 the furtherance of the Community Redevelopment Law and is thereby unauthorized." The period referred to is for any transfer made after January 1, 2011. The RDA transferred funds to the City after January 1, 2011; therefore, the asset transfers are unallowable under H&S Code section 34167.5.

Further, the SCO's authority under H&S Code section 34167.5 extends to all assets transferred after December 31, 2010, by the RDA to the city or county, or city and county that created the RDA, or any other public agency. This responsibility is not limited by the other provisions of the RDA dissolution legislation, including H&S Code section 34167(d), which allowed the RDA to continue to make payments under enforceable obligations to private third parties.

The Finding and Order of the Controller remains as stated.

**Schedule 1—
Unallowable RDA Asset Transfers to
the City of West Covina
January 1, 2011, through January 31, 2012**

Date	Description	Amount
Transfers for promissory note dated May 2, 2000		
1/31/11	Payment of interest on note payable	\$ 2,500
1/31/11	Payment of principal and interest on note payable	20,833
2/28/11	Payment of interest on note payable	2,500
2/28/11	Payment of principal and interest on note payable	20,833
3/31/11	Payment of interest on note payable	1,210
3/31/11	Payment of principal and interest on note payable	10,083
4/30/11	Payment of interest on note payable	3,750
4/30/11	Payment of principal and interest on note payable	31,250
5/31/11	Payment of interest on note payable	3,750
5/31/11	Payment of principal and interest on note payable	31,250
6/21/11	Payment of principal and interest on note payable	602,625
6/30/11	Payment of principal and interest on note payable	31,250
7/31/11	Payment of principal and interest on note payable	31,250
8/31/11	Payment of principal and interest on note payable	31,250
9/30/11	Payment of principal and interest on note payable	31,250
10/31/11	Payment of principal and interest on note payable	31,250
11/30/11	Payment of principal and interest on note payable	31,250
12/31/11	Payment of principal and interest on note payable	31,250
1/31/12	Payment of principal and interest on note payable	5,024,194
		<u>5,973,528</u>
Transfers for promissory note dated June 15, 2010		
1/31/11	Payment of interest on note payable	8,333
1/31/11	Payment of interest on note payable	2,083
2/28/11	Payment of interest on note payable	8,333
2/28/11	Payment of interest on note payable	2,083
3/10/11	Payment of principal and interest on note payable	2,002,688
3/10/11	Payment of principal and interest on note payable	500,672
		<u>2,524,192</u>
Total unallowable transfers		<u>\$ 8,497,720</u> ¹

¹ See the Finding and Order of the Controller section.

**Attachment—
City and Successor Agency’s
Response to Draft Review Report**



*Finance and Administrative
Services Department*

October 9, 2013

Steven Mar
Chief, Local Government Audits Bureau
State Controller's Office, Division of Audits
P.O. Box 942850
Sacramento, CA 94250-2874

Re: State Controller's Draft Asset Transfer Review – Community Development
Commission of West Covina

Dear Mr. Mar:

The West Covina Successor Agency (“Successor Agency”) and City of West Covina (“City”) are in receipt of the State Controller’s (“SCO”) Draft Asset Transfer Review (“Draft Audit”) concerning the Community Development Commission of West Covina (“Agency”).¹ The Successor Agency and City respond as follows to the finding and order presented in the Draft Audit, set forth fully below for ease of reference.

Finding and Order of the Controller

**FINDING –
Unallowable asset
transfers to the City
of West Covina**

The Community Development Commission of West Covina (RDA) made unallowable transfers of \$8,497,720 to the City of West Covina after January 1, 2011, which were not contractually committed to a third party prior to June 28, 2011.

Unallowable asset transfers were as follows:

1. The RDA and the City entered into a financing agreement dated May 2, 2000, per Resolution No. 551, establishing a \$5.6 million

¹ The Draft Audit is dated September 30, 2013, but was not received by the City until October 7, 2013. This correspondence is submitted within the SCO's ten (10) day response deadline.

line of credit to benefit the Citywide Project Area and the Merged Project Area. Our review found that the RDA made unallowable principal and interest payments (transfers) in the amount of \$5,973,528 between January 31, 2011, and January 31, 2012.

2. The RDA and the City entered into a financing agreement per Resolution No. 2010-35, establishing a \$2 million loan; and a second agreement per Resolution No. 2010-36, establishing a \$500,000 loan. Per financing agreements dated June 15, 2010, these loans were to fund project and administrative expenses for the West Covina Merged Redevelopment Project Area and the Citywide Project Area, respectfully. Our review found that the RDA made unallowable principal and interest payments (transfers) in the amount of \$2,524,192 between January 1, 2011, and March 10, 2011.

Pursuant to Health and Safety (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, that were not contractually committed to a third party prior to June 28, 2011.

Order of the Controller

Based on H&S Code section 34167.5, the City of West Covina is ordered to reverse the asset transfers described above and in Schedule 1, in the amount of \$8,497,720, and turn them over 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).

Response by Successor Agency and City

RESPONSE – Asset transfers to the City of West Covina were lawful when made, and SCO’s finding / order exceed its authority under H&S Code § 34167.5

As an initial matter, the SCO’s draft findings are the subject of a pending lawsuit to which the SCO is a named defendant: *West Covina Successor Agency, et al. v. Matosantos, et al.* (Sac. Sup. Ct. Case No. 2013-80001479). The Successor Agency and City expect the subject matter of the Draft Audit to be resolved by the court in that action. That said, the Successor Agency and City provide the below response to the SCO’s Draft Audit in efforts to comply with the SCO’s audit process, and in further attempts to resolve these issues informally.

The Successor Agency and City acknowledge that, during the applicable review period, \$5.9 million was transferred by the RDA to the City in repayment for amounts it borrowed under the financing

agreement approved by Resolution Nos. 551 (“Financing Agreement”), and \$2.5 million was transferred by the RDA to the City in repayment for amounts it borrowed under the loan agreements established by Resolutions Nos. 2010-35 and 2010-36 (“Cash Flow Loan”).

The Financing Agreement was executed on May 2, 2000, to bridge a funding gap in the Agency’s Five Year Redevelopment Plan. By its terms, the City extended a \$5.6 million “line of credit” to the Agency, and the Agency was required to repay all amounts borrowed thereunder, plus interest, in accordance with an established prepayment schedule, and with no prepayment penalty. The Cash Flow Loan was an annual “short-term” loan extended from the City to the Agency to cover the latter’s ongoing operating expenses pending its receipt of property tax revenues later in the fiscal year. The Agency was required to repay the Cash Flow Loan, plus interest, no later than June 30, 2011.

When the Challenged Payments were made (between January 1, 2011 and January 31, 2012), the Financing Agreement and Cash Flow Loan were enforceable agreements under, as applicable, California’s Community Redevelopment Law (“CRL”) and California Assembly Bill (“AB”) 1x 26. **More specifically, prior to enactment of AB 1x26, the Financing Agreement and Cash Flow Loans were enforceable contracts** pursuant to, *inter alia*, H&S Code § 33125(c) – authorizing redevelopment agencies to execute contracts necessary or convenient to the exercise of their powers. **After enactment of AB 1x26, the agreements were “enforceable obligations”** pursuant to H&S Code section 34167(d)(2) – loans of money borrowed by the RDA for a lawful purpose to the extent they are legally required to be repaid pursuant to a required repayment schedule or other mandatory loan terms – and section 34167(d)(5) – legally binding and enforceable agreements or contracts not void as violating the debt limit or public policy. In addition, both agreements and the Challenged Payments were listed on the RDA’s approved “Enforceable Obligations Repayment Schedule” (“EOPS”). (§ 34167(h) [payments listed on EOPS shall be made]; *see also* §§ 34167(f) [AB 1x26 did not impair authority to perform enforceable obligations], 34169(a) [RDA required to continue to make payments due on enforceable obligations].) And, at the time, neither the Financing Agreement nor Cash Flow Loan had been invalidated by H&S Code section 31478, which did not become effective until February 1, 2012. (§ 34178 [*Commencing the operative date of this part...arrangements between the city...that created the redevelopment agency and the redevelopment agency are invalid*] (italics added)].)

The SCO's determination that the Challenged Payments were "unallowable" is incorrect. As set forth above, applicable law in effect at the time recognized the validity of the Financing Agreement and Cash Flow Loan, and the Challenged Payments were made pursuant to their attendant repayment schedules and the approved EOPS. To the extent the SCO's findings suggest the RDA and City engaged in fiscal impropriety and/or unauthorized financial transactions by way of the Challenged Transfers, such findings are not supported and should be revised. That the Challenged Payments were lawful when made should be highlighted in the SCO report, so as to avoid confusion by members of the public and third-party investors interested in Successor Agency / City business.

The SCO relies on H&S Code section 34167.5 as authority to reverse the Challenged Transfers. This section provides in pertinent part:

"If such an asset transfer [between a RDA and a city] did occur during that period and the government agency is not contractually committed to a third party for the expenditure or encumbrance of those assets, *to the extent not prohibited by state or federal law*, the Controller shall order the available assets to be returned to the redevelopment agency or...the successor agency..." (italics added).

As evidenced by the italicized text, H&S Code section 34167.5 authorizes the SCO to demand the return of transferred assets only "to the extent not prohibited by state or federal law." The SCO's order to reverse the Challenged Transfers violates this limitation. Set forth above, applicable law authorized the RDA to make the Challenged Payments and the City to deposit such amounts into its general fund. The SCO's order violates AB 1x26's mandate that "enforceable obligations" be performed, violates Proposition 22 by reallocating / recapturing tax increment revenues allocated to and spent by the RDA, and violates Article XVI, section 6 of California's Constitution by compelling the transfer of City general fund monies to the Successor Agency. Because the SCO's order reversing the Challenged Payments violates state law in these respects, and others, it exceeds the SCO's authority under H&S Code section 34167.5, and should be reversed.

In addition, the SCO's determination that the City is not contractually committed to a third party for the expenditure or encumbrance of the Challenged Transfers is incorrect. The City's 2013-2014 fiscal year budget (and financial projections moving forward) was developed in justified reliance on the retention of the value of the Challenged

Payments, and such funds were assumed by the City in making its budgetary and financial commitments, including those to public health and safety service providers, employee salaries, and City contractors. Reversal of the Challenged Payments undermines these financial commitments to third parties, and exceeds the SCO's authority under H&S Code section 34167.5.

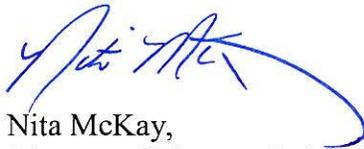
Conclusion

The Successor Agency and City respectfully request the SCO:

1. Reverse its finding that the Challenged Payments were "unauthorized," as applicable law in effect at the time authorized and/or required the payments be made;
2. Reverse its order that the Challenged Payments be reversed, as the order violates state law in various respects, including AB 1x26 and California's Constitution.

In closing, the Successor Agency and City appreciate the opportunity to respond to the SCO's Draft Audit, and are available to provide additional and/or clarifying information as needed. We request the SCO reconsider its Draft Audit finding and order in light of the foregoing. Should you have any further questions or concerns, please contact the undersigned.

Very truly yours,



Nita McKay,
Director of Finance & Administrative Services

cc: Jeffrey v. Borwnfield, Chief, Division of Audits, SCO
Richard J. Chivaro, Chief Legal Counsel, SCO
Scott Freesmeier, Audit Manager, SCO
Claudia Corona, Auditor-in-Charge, SCO
Daniela Anechitoaie, Auditor, SCO
Christopher Chung, City Manager
Mike Lee, Assistant City Manager
Arnold Alvarez-Glasman, City Attorney
Christopher Cardinale, Deputy City Attorney

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