CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

COUNCIL AGENDA: 06-27-06
ITEM: 4.4

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Paul Krutko
Larry Lisenbee

SUBJECT: SEE BELOW

DATE: June 16, 2006

Approved

Date 6/19/06

COUNCIL DISTRICT: # 3
SNI AREA:

SUBJECT: Approval of revised business terms for the lease of City Hall retail space, including a City contribution of $300,000 for Master Tenant improvements to the interior shell, and adoption of a resolution authorizing the City Manager to execute a lease with the revised terms and conditions.

RECOMMENDATION

It is recommended that the City Council:

a) Approve the proposed revised business terms and conditions of the proposed lease;
b) Approve the following 2005-2006 Appropriation Ordinance Amendments in the General Fund:
    1) Establish a city-wide appropriation for City Hall Retail Space in the amount of $300,000.
    2) Decrease the Contingency Reserve by $300,000.
c) Adopt a resolution authorizing the City Manager to negotiate and execute a final lease agreement in accordance with the revised business terms and conditions.

OUTCOME

Allocation of the requested funds will facilitate the Master Tenant's ability to proceed with finalizing leases with two sub-tenants for the New City Hall space.

BACKGROUND

On June 28, 2005, The City Council approved the selection of Donald F. Imwalle, Imwalle-City Hall, LLC a California Limited Liability Company, as the preferred proposer for the master tenant

for the development of the restaurant space in the City Hall retail space along Fourthth Street and approved the proposed business terms to be included in the lease agreement. The City Council also adopted a resolution authorizing the City Manager to negotiate and execute a lease agreement for the space in accordance with the initial proposed business terms set forth in the staff memorandum. Three proposers responded to the RFP, including Don Imwalle, Starbucks Coffee Company, and Subway Sandwich and Salads. Imwalle was the only developer to respond to the RFP.

The City Hall project establishes a new civic landmark in Downtown San Jose. The project includes approximately 6,000 square feet of retail space located on the Fourth Street side of the New City Hall. Don Imwalle has extensive experience in creating and sustaining retail centers throughout San Jose and the South Bay. Imwalle has excellent relationships with a wide array of tenants and is respected for his on-going management of those retail centers.

Provided below is an explanation of costs associated with the project. An amount of $300,000 is requested to assist with tenant improvement costs in acknowledgement of higher project costs and lower initial revenues associated with the project. Staff provides below an update on Labor Peace provisions to be included in the City's Master Tenant lease with Don Imwalle. Imwalle will be responsible for ensuring that project's tenant's leases include the appropriate Labor Peace requirements throughout the term of the lease.

ANALYSIS

The City Hall retail space located on the Fourth Street side of the New City Hall will serve the City's roughly 1,700 City Hall employees, approximately 1,000 City Hall daily visitors and the broader Downtown community. The retail space is intended to complete the retail frontage along Fourth Street from San Fernando to Santa Clara Street. The three restaurant spaces envisioned will give employees, residents, students and visitors quick and delicious options for dining.

Lease negotiations for the project are down to the last technical details, but have been difficult due to greater than anticipated costs, lower rents offered by the tenants, and the challenges of integrating privately operated retail space into a public building.

The retail space was constructed to "cold shell" condition. In light of the overall project costs for New City Hall no tenant improvement dollars were allocated to the project and basic systems for the retail space were not completed. After the June 28, 2005 Council approval of Imwalle as the Master Tenant, Imwalle commenced work on refining his initial analysis of costs associated with build out of the tenant space and found them to exceed estimates. Additional costs were attributed to items such as the build out of the ventilation systems, project flooring and industry wide escalation of construction costs.

An additional complicating factor related to the project is the fact that the retail space is a part of, not distinct from, City Hall itself. Electricity, gas, water and sewer systems are shared between the public and private elements of the City Hall complex. City staff desired to assure that no action in

the retail space interfere with or endanger on-going City operations. As a result, additional coordination and oversight is required.

In addition to rising costs, the anticipated revenue associated with the project decreased. At the time of the RFP, sub-tenants provided an estimated rent structure to the Master Tenant. The sub-tenants then began an intensive study of the site location. After careful review the sub-tenants decreased the amount they are willing to pay in rent for the space. The area surrounding City Hall remains an area in transition. The project sub-tenants are confident that the retail environment in the area will continue to grow stronger over time as new residential projects come on line, new retail projects are completed, and linkages with San Jose State University are strengthened. But in the short term, lowered revenue projections from the sub-tenants result in lower market rents.

The rent structure initially proposed included:

- Years 1-10 $35,000 per year
- Years 11-15 $130,000 per year
- Years 16-20 $143,000 per year
- Years 21-25 $157,000 per year.

The revised rent structure is lower in initial years to reflect lower tenant rents.

Annual rentals:

- Years 1-5 $6,000 per year.
- Years 5-10 $12,000 per year.

The revised rent structure is actually a stronger long-term proposal. After the first ten years of the project, Imwalle and the City will function as partners in the project. The City will receive 50% of the net sublease income received by the Master Tenant during each calendar year. As the retail environment in Downtown solidifies, the City and Imwalle will effectively partner, and share equally, in the revenues from the project. It is recommended that $300,000 from the Contingency Reserve in the General Fund be allocated for this purpose.

The Master Tenant's request for an amount of $300,000 to assist in the build out of tenant improvements is the result of both the increased costs and lower revenues associated with the project. The Master Tenant will be required to demonstrate the expenditure of $854,439 prior to receiving any portion of the $300,000 in tenant improvement dollars to be provided by the City. Don Imwalle is making a substantial investment in the new City Hall retail space, and is placing his own capital at risk prior to any City contribution for tenant improvements.

The original business terms anticipated one 10-year option to renew the lease. An additional 10-year option for a total of two 10-year options, or a total of a 45-year lease term, is included in the project. The additional term allows the Master Tenant to recoup project dollars in recognition of the significant up front investment made by the Master Tenant.

The original business terms also anticipated that the rental commencement would occur 180 days from lease signing. The lease now includes a provision that the rent payments shall begin at the earlier of (a) the date the first subtenant opens for business or (b) 180 days following the date when all of the contingencies have been satisfied by the Master Tenant. Project contingencies specify that the Master Tenant shall have entered into subleases for at least 2/3 of the floor area of the retail space and that all permits and approvals for the construction of the Master Tenant's work and subtenant's work for at least 2/3 of the space have been issued. If all of the above contingencies have not been fully satisfied by the Master Tenant on or before 240 days following the effective date, either Landlord or Master Tenant may terminate the lease through written notice.

Attachment 1 to this memorandum is a summary of the proposed revised lease terms and conditions as negotiated between the parties.

Labor Peace Update

Don Imwalle has indicated that he, personally and professionally, understands the importance of a fair and effective means to resolve work-related complaints and problems. Mr. Imwalle has indicated that all sub-tenant agreements will, in general terms, include employment practices, policies, or measures that the tenants generally or typically utilize in order to minimize the likelihood that any labor dispute or unrest will occur during the term of the City Contract. The Master Tenant acknowledges that the consent of the City to any sublease will be conditioned on the inclusion of an appropriate Labor Peace Plan. However, the failure by the sub-tenants to achieve Labor Peace would not constitute a default by the Master Tenant under the Master lease.

ALTERNATIVES

The requested funds are necessary to proceed with leasing of the New City Hall Retail space. Staff would be required to initiate a new Request for Proposals to identify either a new Master Tenant or individual sub-tenants for the space if the requested funds cannot be allocated.

PUBLIC OUTREACH

The New City Hall Retail Request for Proposals (RFP) was released in April of 2005 and was advertised broadly to area businesses, brokers, and developers.

COORDINATION

This memorandum has been coordinated with the City Attorney's Office, the Planning, Building and Code Enforcement Department, and Office of Equality Assurance.

COST IMPLICATIONS

This action would reduce the General Fund Contingency Reserve by $300,000.

BUDGET REFERENCE

Fund #	Appn #	Appn. Name	RC#	Total Appn.	Amt. for Contract	2005-2006 Adopted Operating Budget Page	Last Budget Action (Date, Ord. No.)
001	7901	Contingency Reserve		$22,784,462	$300,000	Page IX-27	6/06/2006 Ord. No. 27764
		Total		**$22,784,462**			

CEQA

Civic Plaza Environmental Impact Report, Resolution 68905.

PAUL KRUTKO
Director, Office of Economic Development

for LARRY LISENBEE
Director, Budget Office

For questions please contact Paul Krutko, Director, Office of Economic Development, (408) 535-8181.

Attachment 1

Summary of Lease Provisions

Contractual relationship

The lease will be between Imwalle-City Hall, LLC and the City. The assets of the LLC will be limited to the lease, the revenues from any subtenants and the improvements made pursuant to the lease. Imwalle will serve as the Master Tenant, and will provide initial improvements to bring the premises to warm shell, obtain and manage the subtenants that provide the food services, and provide ongoing maintenance of the leased premises.

Final "fit-out" of the subtenant space will be the responsibility of the subtenant and is a contractual matter between Imwalle and the subtenants (subject to City's normal permitting processes). The City may approve subtenants, and may not unreasonably withhold its consent.

Basic Financial Provisions

Term: An initial term of 25 years, and grants the Master Tenant 2 ten year options to renew, for a potential total term of 45 years.

Rent: The rentals to the City for the first ten years of the lease are to be $6,000 per year for years 1-5 of the lease, and $12,000 per year for years 6 through 10, payable annually in advance.

At the 11th year of the lease, the City will receive 50% of net revenues, payable annually in arrears. The revenues are principally the rentals received by the Master Tenant from the subtenants, minus certain deductions for certain expenses incurred by the Master Tenant in subleasing the space, such as tenant improvement costs, leasing commissions, specified accounting or legal expenses, taxes, insurance, and a management fee of 5% to the Master Tenant.

City Contribution: The lease provides for a City contribution of $300,000 to the costs of bringing the interior space to "warm shell". The City's contribution will not be made until Imwalle has incurred expenses in excess of $857,476.00 in constructing the space. Due to the fact that not all subtenants are presently known, the lease does not require an estimated amount for the subtenants to expend on their spaces.

Lease Contingencies: The term of the lease does not commence until subtenants for 2/3 of the space have been approved by Imwalle and the City, and all permits and approvals for the construction of the Master Tenant's improvements and the Subtenant's improvements have been obtained on terms and conditions reasonably satisfactory to the Master Tenant. If all of the contingencies to the commencement of the lease term have not been fully satisfied 240 days after execution of the lease, either party may terminate the lease.

Rental payments commence on a pro-rated basis as space is occupied by subtenants. Full rentals commence no later than 180 days after all of the lease contingencies discussed above have been removed and the term of the lease thereby commenced.

Leased Premises: The leased premises include approximately 5365 square feet of interior space, the service corridor, trash area, and exterior patio area. A sidewalk café permit is required for use of the exterior area.

Loss or interference with outdoor patio space: The lease requires the City to compensate the Master Tenant if, in the future, regulations are issued (or any other actions are taken by City), which interfere with the Master Tenant's use of the exterior seating area (not due to noncompliance of the Master Tenant or subtenant with the Sidewalk Café permit). The amount is based upon a formula to compensate for lost revenues and expenses incurred by the Master Tenant, as follows: (a) the unamortized cost of the improvements, alterations and leasehold improvements made by Master Tenant and its Subtenants to the Premises (amortized on a straight line basis over ten years) plus (b) an amount calculated to be the projected loss of Master Tenant's share of sublease over the remainder of the initial term, in accordance with the following formula: fifty percent (50%) of the average of the net sublease income from the preceding three (3) calendar years, increased by two percent per annum (compounded) for the remainder of the initial term, and discounted to present value as of the date such damage accrues to Master Tenant.

Operational Provisions

Hours of Operation: The Master Tenant is to use its best efforts to cause at least one subtenant to be open for business from 7 AM to 7 PM, Monday through Friday, with the ability to close on all national, state, and City holidays.

Exclusivity: The Master Tenant has the exclusive rights to operate as the sole fixed location restaurateur within the City Hall complex. These rights do not preclude food service brought into City Hall under the following circumstances:

- City Hall employees bringing into City Hall food service or products as long as such foods are for their own use and not for commercial resale;
- catering of special events by off-site food service providers;
- any internal fundraisers conducted by City employees;
- the installation of vending machines in City Hall;
- any events authorized on the Plaza under the Municipal Code

Approval of subtenants: The Master Tenant is obligated to use its best efforts to find reasonable restaurant subtenants for the premises with an effort to match downtown needs and the needs of City employees. If after such efforts, the Master Tenant is not successful at locating subtenants of the type and quality preferred by the City (such as Starbucks or Prolific Oven), the Master Tenant may sublease to other subtenants as are available for the space, and the City cannot unreasonably withhold its consent.

Master Tenant/City contacts: The City Manager is delegated the authority to approve or disapprove proposed subtenants in the lease. At the request of Imwalle, the Director of OED has been initially designated the City's principal point of contact for requests of Imwalle to the City.

City Requirements: Payment of prevailing wages is required for construction by the Master Tenant. The lease contains the standard City provisions regarding non-discrimination, reference to City's ethics and revolving door ordinances, First Source Program and Environmental Procurement Program.

Labor Peace Update: The specific Labor Peace provision has not yet been completed, but the Labor Peace provision will be as described in the staff memorandum.