November 10, 2021

To: The Board of Land and Natural Resources (via email: blnr.testimony@hawaii.gov.

Re: Testimony on Agenda Item D-4 (Amendment of Extended, Amended, and Restated General Lease No. S-3961, Hilo Hawaiian Associates, Inc., Lessee; Government Lands Situate at Waiakea, South Hilo, Hawaii, Tax Map Key: (3) 2-1-003:005)

My name is Keith Chun. I was formerly employed by DLNR's Land Division ("LD") from 2001 to 2016 as its Planning and Development Manager. I offer the following comments and suggestions to Agenda Item D-4:

1. <u>Land Division incorrectly characterizes the proposed amendment to the Hilo Hawaiian Hotel as being a standard provision that was "inadvertently omitted"</u>.

   Contrary to LD's attempt to explain the poorly drafted lease being "inadvertent", LD's administrators were specifically made aware of these problems in 2016. (see email to Russell Tsuji, Kevin Moore and Ian Hirokawa dated March 1, 2016, a copy of which is attached as **Exhibit A**). Exhibit A also includes a reply from Russell Tsuji in which he stated essentially says all LD percentage rent leases are "just standard". The LD administrators chose to ignore these issues in 2016, and as such, their attempt to now try to assert it was inadvertent is disingenuous.

   Furthermore, an audit of DLNR's Special Land and Development Fund published in June 2019 (the "2019 Audit") also identified problems with LD's procedures for collecting and monitoring percentage rents. (see attached **Exhibit B**)

   Finally, the House of Representatives Investigative Committee ("HIC") that was formed earlier this year to investigate DLNR's responses to the 2019 Audit also discussed this issue.

   LD is now attempting to address these problems, but it has taken over five years since I notified LD of these problems, and over two years since the 2019 Audit was published. LD's attempt to characterize this as an "inadvertent omission" is clearly inaccurate and intentionally misleading.

2. <u>The proposed amendment to the Hilo Hawaiian Hotel Lease (the "Lease") will result in conflicting terms and conditions</u>.

   The proposed amended language would be added as a Paragraph 3 of the Lease and require the lessee to percentage rents, <u>annually</u> and <u>in arrears</u> no later than 180 days after the end of the lessee's fiscal year.

   This, however, would conflict with Paragraph 2 (on Page 2) of the Lease, which is not being amended. Paragraph 2 requires percentage rents (and base rents) to be paid <u>semi-annually</u>, and <u>in advance</u> on January 12th and July 12th of each year.

3. The LD Administrators Lack Knowledge of Basic Lease Provisions.

The Lease was drafted personally by Kevin Moore, LD's Assistant Administrator. Mr. Moore was directly involved in drafting the Lease because the Lease was amended pursuant to Act 219 (2011) and required direct attention of personnel above the staff level. However, the resulting Lease clearly shows a lack of understanding of basic lease terms and conditions.

In contrast, the proposed amended provisions sought in this Board submittal were taken directly from the lease for the Naniloa Hotel (Lease No. S- 5844), which I personally drafted in 2005. I do not believe these provisions can be found in any other LD lease, and as such, it is inappropriate for LD to refer to these as "standard provisions".

As an example, the deadline for payment of percentage rents in the proposed amendment is 180 days after the end of the lessee's fiscal year. This time period was negotiated to coincide with the time period required for the lessee to have audited financial statements prepared. This would allow LD to confirm the lessee's annual revenues against the revenues reported in its audited financial statements. However, this is not a "standard" provision as not all lessees have audited financial statements. For those lessees, it would be prudent to require percentage rents to be paid sooner.

As I indicated in my 2016 email, it is important that percentage rent provisions provide LD with the rights necessary to confirm the amounts of percentage rents and to audit a lessee's records if necessary. The Naniloa Hotel lease provides a viable mechanism by tying the payment of percentage rents to the lessee's fiscal year and the period covered by its financial statements.

In contrast, Paragraph 2 of the Hilo Hawaiian Hotel lease requires semi-annual payments for periods from January 12th to July 11th, and from July 12th to January 11th of each year. I do not know of any company that has financial statements prepared for such periods, and as such, would need to create separate records specifically for the purpose of calculating percentage rents. Moreover, the data provided in the Board submittal show percentage rents being collected for each calendar year period, which is clearly not in accordance with the time periods required in Paragraph 2 of the Lease

The fact that Paragraph 2 also requires percentage rents be paid in advance of the revenues being generated is also baffling.

Clearly, there are problems with LD's procedures for collecting and monitoring percentage rents, as pointed out in the 2019 Audit. However, the fact that LD's administrators cannot get a grasp on basic lease provisions (further evidenced by Assistant Administrator Moore's drafting of the Lease) should be very worrisome to the Board.

4. LD Administrators have Ignored Other Staff Recommendations in the Past.

In addition to ignoring my memo regarding the percentage rent provisions in the Lease, LD administrators have ignored or rejected other recommendations, including but not limited to recommendations made in 2012 to increase revocable permit rents, proposals in 2015 for a long-range strategic plan, and a 2015 marketing strategy proposal. These are only a few examples, but all were rejected by Mssrs. Tsuji, Moore and Hirokawa, only for such problems to later be publicly exposed, e.g., in the 2019 Audit and in the media (below are links to the Honolulu Star-Advertiser's three-part front page series on DLNR's mismanagement)

https://www.staradvertiser.com/2018/11/20/hawaii-news/leaders-dismiss-warnings/
https://www.staradvertiser.com/2018/11/19/hawaii-news/booming-market-idle-lands/
https://www.staradvertiser.com/2018/11/19/hawaii-news/lease-extensions-stir-controversy/

I have been subpoenaed to testify before the HIC on matters raised in the 2019 Audit and understand that Board members may also be called to testify. As such, you should be aware that some of the problems that may be discussed were issues that LD administrators chose not to present to the Board.

Thank you,

Keith Chun

cc: House Investigative Committee Chairperson Bellati
House Investigative Committee Vice-Chairperson Ichiyama

Chun, Keith K

From: Chun, Keith K
Sent: Tuesday, March 01, 2016 2:26 PM
To: Tsuji, Russell Y; Moore, Kevin E; Hirokawa, Ian C
Subject: RE: Proposed DOBOR legislation

Thanks.

FYI, I found the Hilo Hawaiian lease to be quite different from other percentage rent leases involving both private and public lands. I noticed this when I was researching percentage rent leases to support DOBOR's proposed legislation (particularly DOBOR's proposed amendment to HRS 171-36(a)(6) that requires percentage rents be calculated on all of the lessee's gross revenues, plus all of the sublessees' gross revenues).

My research included leases of both private and public lands. The public land leases included leases from DOBOR, Land Div, and DHHL. I also interviewed brokers, appraisers, bankers (including a banker for one of the investors in the Hilo Hawn) and real estate attorneys (including one of the attorneys for the lessee of the Westridge shopping center, who also developed the 500,000 sf Torrance Crossroads shopping in LA). Each person I spoke with was surprised with the requirement currently in HRS 171-36(a)(6). I also touched base with Gordon at HDLO.

I submitted the results of my research in a memo to DOBOR, but have summarized the portion of the Hilo Hawaiian lease below in case any of you are interested. Feel free to ignore any or all of it.

Hilo Hawaiian extended, restated and amended lease dated 12/29/15:

1. Base and percentage rents are both due on the 12th of each and every January and July. However, as recently as last week, SLIMS indicated no such rents were billed or paid for the base and percentage rents due on January 12, 2016. I did not look into whether an NOD has been issued.

2. Percentage rents must be paid in advance. I'm not sure how LD intends to calculate the percentage rents in advance before any revenues are earned or reported. (It's possible to do it based on estimated/projected revenues for future periods, but LD will need to do a reconciliation at the end of the actual period. This, however, does not seem to have been contemplated for the Hilo Hawaiian lease, especially since there is no language in the lease about any reconciliation).

3. There is no definition of gross revenues in the lease. Defining gross revenues is often advisable to avoid disputes in the future, especially in this lease because of the unique requirement of HRS 171-36(a)(6) re: gross revenues of sublessees and because the Hilo Hawaiian has many sublessees (i.e., a restaurant, bar, convenience store, kiosks, hair salon, etc). In addition, hotels usually want to be sure specific items are not included as part of gross revenues (e.g., GE tax, TAT, sales of furniture, etc). The Naniloa lease includes a definition of gross revenues that addresses all of these issues.

4. There is no requirement that the lessee submit gross revenue reports, so there's so no way for LD to verify the percentage rents (or do a reconciliation if the percentage rent is to be paid in advance and be based on projected revenues).

5. The lease does not provide LD with any audit rights (i.e., the right to audit the lessee's books and records, especially re: gross revenues).

EXHIBIT A

6. It's unusual for percentage rents to be based on revenues for periods beginning and ending in the middle of the month (i.e., the 12th of the month). That would require the lessee to prepare special gross revenue reports that are separate and distinct from their normal accounting records, which generally cover normal accounting periods (e.g. month-end, fiscal year-end). . . but since there is no revenue reporting requirement, I guess it doesn't matter.

7. LD will be entitled to percentage rents once Hilo Hawaiian's revenues exceed $9.2 million (based on the $182K min base rent). Per an appraisal in file, the lessee's gross revenues for 2009-2011 exceeded $10 million in each year . . . and that is without including the sublessees' gross revenues. The appraisal also projected stabilized revenues of approx. $12 million (again, w/o including the sublessees' revenues). As such, LD should expect to receive percentage rent payments from Hilo Hawaiian. (see #4 above . . . Hilo Hawaiian is delinquent on the base and percentage rent payments that were due on January 12, 2016.

8. There's a unique reason that I requested a "blended" rate for the Naniloa percentage rent instead of the varied percentages normally seen in hotel leases (e.g., 12% of room revs, 6% of food and beverage, 3% of concessions). Please let me know if you would like details on that issue.

In sum, I found many of these lease provisions to be uncommon in most of the leases I've seen over the years, but would be interested to know if these provisions are the trend in the industry and are being incorporated in all of the newer leases.

Thanks,
KC

From: Tsuji, Russell Y
Sent: Wednesday, January 27, 2016 12:36 PM
To: Chun, Keith K; Moore, Kevin E; Hirokawa, Ian C
Subject: RE: Proposed DOBOR legislation

Not really. Most are just standard—a percentage of gross. And Windfarms are unique and not good examples.

From: Chun, Keith K
Sent: Wednesday, January 27, 2016 11:16 AM
To: Tsuji, Russell Y <Russell.Y.Tsuji@hawaii.gov>; Moore, Kevin E <kevin.e.moore@hawaii.gov>; Hirokawa, Ian C <ian.c.hirokawa@hawaii.gov>
Subject: Proposed DOBOR legislation

All,

I'm working on the proposed DOBOR legislation and wanted to review some the percentage rent provisions in DLNR leases. Are there any LD leases that you would consider good examples? E.g., Westridge shopping center, Hilo Hawaiian Hotel, Naniloa, any of the car dealership leases?

Thanks,
Keith

Procedures for the collection and review of percentage rent received from lessees need improvement.

According to DLNR, there were 27 lease agreements containing percentage rent clauses (rent based on a percentage of the lessee's gross receipts) as of June 30, 2017. DLNR may require sales audits be performed by independent auditors to verify the calculation of percentage rent in accordance with the lease agreement. Otherwise, DLNR relies on self-reported revenues and percentage rent calculations contained in the certified statement of gross receipts submitted by lessees.

KKDLY noted that DLNR does not formally document its review and approval of the certified statement of gross receipts submitted by lessees to indicate that DLNR staff determined the reported revenues were reasonable and that the calculation of percentage rent was in accordance with the lease agreement. The certified statements of gross receipts should identify the DLNR staff who reviewed them and the dates of the review. For practical reasons, the level of review will vary depending on the percentage rent due.

DLNR should establish documented procedures related to the collection of percentage rents due from lessees to provide a clear, consistent timeframe for the receipt of sales audit reports and certified statement of gross receipts for all leases with percentage rent clauses. DLNR should also have procedures to follow if lessees fail to submit required sales audit reports, certified statements of gross receipts, or payment of the required percentage rent.

Revenues from ceded lands have not been transferred to the general fund.

Twenty percent of the revenues DLNR receives from certain leases and permits of ceded lands are required to be transferred to the Office of Hawaiian Affairs (OHA). The remaining 80 percent of those ceded land revenues are held by the State as a public trust for the following purposes: (1) support of public education; (2) betterment of the conditions of Native Hawaiians; (3) development of farm and home ownership; (4) public improvements; and (5) provision of lands for public use.

KKDLY found that from FY2015 through FY2017, DLNR received \$47.1 million in revenue from the ceded lands that it manages. In each of those three years, the department remitted to OHA an average of \$3.1 million, for a total of \$9.4 million, which was 20 percent of the ceded lands revenue, as required by law.

EXHIBIT B