

Memorandum

City of Lawrence

City Attorney's Office

TO: City Commission
CC: Thomas M. Markus, City Manager
FROM: Toni R. Wheeler, City Attorney and
Randy F. Larkin, Senior Assistant City Attorney
DATE: April 12, 2017
RE: Proposed Settlement Agreement and First Amendment to Redevelopment Agreement

Please place on the City Commission's regular agenda for April 18, 2017, consideration of (1) a proposed Settlement Agreement in the City's lawsuit styled, *City of Lawrence, Kansas v. Thomas Fritzel, Oread Inn, LC, Oread Wholesale, LC, DFC Company of Lawrence, LC and John Doe 1-2*, Case No. 16-cv-2800; and (2) a proposed First Amendment to 12th & Oread Tax Increment Financing District Redevelopment Agreement.

Background

On November 16, 2016, the City filed a civil lawsuit in Douglas County District Court against Thomas Fritzel, Oread Inn, LC, Oread Wholesale, LC, and DFC Company of Lawrence, LC. The City alleged in its lawsuit that the defendants improperly received certain sales tax reimbursements from the City under the 12th & Oread Tax Increment Financing District Redevelopment Agreement ("Redevelopment Agreement"), an agreement entered into by the parties in 2008. The City's lawsuit was initiated after receiving the results of two reports from a certified public accounting and advisory firm that the City hired to assist it in evaluating the sales tax transactions, receipts, and reimbursements in connection with the Redevelopment Agreement between the City and Oread Inn, LC. After the City filed the petition, the defendants removed the lawsuit to the U.S. District Court for the District of Kansas. Additional background information can be found on the City's website, www.lawrenceks.org/cmo/oreadwholesale/.

On January 20, 2017, the federal district court ordered the parties to engage in mediation. Two mediation sessions occurred: on February 14, 2017, and on March 6, 2017. Through mediation and subsequent discussions among the parties' attorneys, the parties have negotiated a proposed settlement of the dispute, the terms of which are summarized below. The governing body must approve the settlement and the amendment to the Redevelopment Agreement in order for the settlement agreement to be effective.

Settlement Agreement Terms

The substantive provisions of the settlement agreement are summarized here.

Management of the Oread Inn – Thomas Fritzel will resign as co-manager of Oread Inn, L.C. and during the term the City is obligated to make reimbursements to Oread Inn, L.C., Mr. Fritzel will not serve as co-manager nor as the Developer’s Representative under the Redevelopment Agreement. Two persons will be appointed to serve as co-managers of Oread Inn, L.C. for the remaining term of the Agreement. Oread Inn L.C. and the City Manager will mutually agree on the two co-managers. If they cannot agree, the City and Oread Inn L.C. will enter into mediation to resolve the disagreement.

Reforming the Redevelopment Agreement - The proposed settlement includes revisions to the Redevelopment Agreement to provide the City greater oversight over the Redevelopment District operations and books and records of businesses operating therein. A summary of the significant revisions to the Redevelopment Agreement is provided below.

Settlement Payment by the Oread Inn - The defendants will pay the City \$650,000 in settlement of the lawsuit. After the City is paid its settlement sum from the funds that the City has been withholding from the developer since the dispute arose, the City will disburse the remaining funds it has held in a manner agreed upon by the parties.

Prohibition on Certain Incentive Requests - Under the proposed settlement, Thomas Fritzel agrees that neither he nor any Fritzel affiliate as defined in the proposed settlement agreement will seek any incentives that involve sales tax reimbursements from the City for a period of five (5) years.

Mandatory Sales Tax Training for Oread Inn Managers - Oread Inn, L.C. and Oread Inn hotel managers will be required to participate in training on sales tax sourcing laws, rules, and regulations.

Dismissal of the Lawsuit - If the settlement is approved, and all conditions precedent are met, the City will dismiss its civil lawsuit against the defendants.

Mediation Costs paid by Defendants The defendants will be responsible for paying the mediator’s costs.

Redevelopment Agreement

The proposed Settlement Agreement includes amending the Redevelopment Agreement to provide the City with enhanced oversight and remedial powers to deter, detect, and remedy transgressions of the reformed Redevelopment Agreement. The substantive terms of the First Amendment include the following:

- (1) In addition to resigning as co-manager of Oread Inn, L.C. (“Developer”), Thomas Fritzel will no longer serve as Developer’s Representative to the City under the Redevelopment Agreement. The Developer’s Representative will be one of the new co-managers of Developer and the City will have the right to approve the person selected to serve as Developer Representative to the City.

- (2) The amount that the City is obligated to reimburse the Developer for certain infrastructure improvements under the Redevelopment Agreement is reduced from \$11,000,000.00, plus interest, to \$8,500,000.00, plus interest. Accordingly, the amount that the City is obligated to reimburse the Developer has been reduced by approximately \$2,500,000.00.
- (3) Under the original Redevelopment Agreement, the City would share equally with the Developer all TIF funds and would receive all TDD funds once the City had reimbursed the amount of \$7,100,000.00 to the Developer. Under the reformed Redevelopment Agreement, that amount has been reduced to \$5,750,000.00. In other words, the City will begin to share in tax proceeds from the Redevelopment District much earlier than it otherwise would under the original Redevelopment Agreement.
- (4) The new management of the Developer shall inform the City Manager of all new commercial entities relocating into the Redevelopment District. In no case shall any affiliate of Thomas Fritzel be permitted in the Redevelopment District without the prior written consent of the City.
- (5) Annually, on November 1 of each year, the City shall have the right to audit all sales tax records of all commercial entities in the Redevelopment District for the preceding year and the Developer shall pay the costs of such audits.
- (6) Annually, on November 1 of each year, the new management of the Developer will certify to the City, under penalty of law, that its sales tax returns for the preceding year are materially accurate and that all sales tax reimbursements made to it as a result thereof are likewise materially accurate.
- (7) The Developer -- except in certain instances involving death, estate planning, or the sale of individual residential condominiums -- is prohibited from transferring any ownership rights or other rights in the Oread Inn Hotel without the prior written consent of the City.
- (8) Any violation of the foregoing or any violation of any residual terms of the original Redevelopment Agreement shall be deemed a default and the City shall have the right to demand that the Developer cure the default. If said default is not cured to the satisfaction of the City, then the City may take whatever legal recourse is necessary to cure the default, including termination of the reformed Redevelopment Agreement.

The City Attorney's Office recommends approval of the Settlement Agreement and First Amendment to the Redevelopment Agreement. We have attempted to anticipate and answer some questions regarding the proposed settlement. Please see attached. [FAQ]

Frequently Asked Questions/Answers April 2017

This is not a complete summary of the proposed Settlement Agreement related to the lawsuit, *City of Lawrence, KS v. Thomas Fritzel, et al.* To be fully informed on the proposed Settlement Agreement, please access the City's website at www.lawrenceks.org/oreadwholesale/.

What steps has the city taken related to this matter since December 2015?

In February 2016, the City issued a notice to Oread Inn, L.C. of a Developer Event of Default under the Redevelopment Agreement. In March 2016, the City obtained from Oread Inn, L.C.'s tenant, Oread Wholesale, L.C., the tax records and documents that Oread Wholesale used to prepare its *original* sales tax returns upon which the City had issued reimbursements under the Redevelopment Agreement. The records (comprised of approximately 15,000 pages), were turned over to the City's accounting consultant for review and analysis. In November 2016, the City made public a report by its accounting consultant, AGH. The City Commission directed the City's attorneys to file appropriate court documents to take action against Oread Inn L.C. and related parties. The City's attorneys filed a petition on November 16, 2016, in Douglas County District Court against Oread Inn, L.C., Oread Wholesale, L.C., DFC Company of Lawrence, Thomas Fritzel, and unnamed persons who may have aided the named parties. The City's lawsuit alleged 11 separate causes of action. In December 2016, the defendants removed the case to federal court. On January 20, 2017, the court ordered mediation. The parties and their attorneys participated in mediation on February 14, 2017, and March 6, 2017.

What does the settlement entail?

Management of the Oread Inn – Thomas Fritzel will resign as co-manager of Oread Inn, L.C. and during the term the City is obligated to make reimbursements to Oread Inn, L.C., Mr. Fritzel will not serve as co-manager nor as the Developer's Representative under the Redevelopment Agreement. Two persons will be appointed to serve as co-managers of Oread Inn, L.C. for the remaining term of the Agreement. Oread Inn L.C. and the City Manager will mutually agree on the two co-managers. If they cannot agree, the City and Oread Inn L.C. will enter into mediation to resolve the disagreement.

Reforming the Redevelopment Agreement between the Oread Inn and the City -- The proposed settlement includes revisions to the Redevelopment Agreement to provide the City greater oversight over the Redevelopment District operations and books and records of businesses operating therein. A summary of the significant revisions to the Redevelopment Agreement is provided below.

Settlement Payment by the Oread Inn -- The defendants will pay the City \$650,000 in settlement of the lawsuit. After the City is paid its settlement sum from the funds that the City has been withholding from the developer since the dispute arose, the City will disburse the remaining funds in the 12th & Oread TIF and TDD funds in a manner agreed upon by the Parties.

Prohibition on Incentive Requests from Thomas Fritzel/associated entities -- Under the proposed settlement, Thomas Fritzel agrees that neither he nor any Fritzel affiliate as defined in the proposed

settlement agreement will seek any incentives that involve sales tax reimbursements from the City for a period of five (5) years.

Mandatory Sales Tax Training for Oread Inn Managers -- Oread Inn, L.C. and Oread Inn hotel managers will be required to participate in training on sales tax sourcing laws, rules, and regulations.

Dismissal of the Lawsuit -- If the settlement is approved, and all conditions precedent are met, the City will dismiss its civil lawsuit against the defendants.

Mediation Costs paid by Defendants -- The defendants will be responsible for paying the mediator's costs.

Why settle now?

This complex lawsuit, if taken to a jury trial, will be expensive and time consuming. Attorneys' fees, expert witness fees, extensive depositions, and lost time by city elected officials and staff were factors considered by the City. While the City's attorneys have confidence in the City's case, juries can be unpredictable, and there is no guarantee the City will prevail in the lawsuit. Even if the City were to prevail, a jury can award less than the total damages sought by the City. Importantly, only a few of the City's legal theories would allow the jury to award the City its attorney's fees and other costs. Early settlement can reduce the City's expenses and bring the case to a conclusion, while still achieving many of the City's goals.

The settlement calls for the defendants to pay \$650,000 to the City. Why this amount?

The sum represents the amount the City contends it overpaid Oread Inn, L.C., with interest (\$492,914.86), plus the City's estimated out-of-pocket costs the City incurred from its investigation of the dispute in 2015 through the start of the court ordered mediation.

What is the total amount of over-reimbursement to the Oread Inn?

This issue was in dispute between the parties. The AGH report includes calculations of reimbursements made to Oread Inn, L.C. based on the sales tax returns provided by Oread Wholesale L.C. which the City believes were over-reimbursed, plus applicable interest calculated based on the definition in the development agreement, which is Wall Street Journal prime rate plus 1%. The City sought repayment of \$492,914.86. This amount was paid under protest by the Oread Inn in late December 2015.

AGH Report*	Over-reimbursement Total	City's Share	County's Share	TDD Taxpayers	Interest
	\$492,914.86	\$232,604.54	\$49,383.29	\$147,606.92	\$63,320.11

The defendants maintain that they owed the City approximately \$90,000.

How will this amount be paid to the City?

The City currently holds \$492,914.86, that Oread Inn, L.C., paid to the City on December 31, 2015, under protest. The City also holds approximately \$700,000.00 in TIF and TDD funds collected in the 12th & Oread special taxing districts. The City has been holding those funds since mid-2015, when it began investigating this matter. To obtain the \$650,000.00 settlement amount, the City will disburse to itself first from the \$492,914.86, and then the remainder from the TIF and TDD funds. After the City has disbursed \$650,000.00 to itself from those funds, it will disburse the remaining TIF and TDD funds in a manner agreed upon by the Parties.

What has the City been doing with TIF and TDD payments from the Oread Inn since this all began?

Since mid-2015, as the City began investigating what appeared to be improprieties in the 12th & Oread TIF and TDD districts, and out of an abundance of caution, the City has been holding all TIF and TDD funds from the 12th & Oread TIF and TDD Districts.

How has the redevelopment agreement between the City and the Oread Inn been reformed?

The reformation of the 12th & Oread Tax Increment Financing District Redevelopment Agreement can be reduced to eight salient points:

- (1) In addition to resigning as co-manager of Oread Inn, L.C. (“Developer”), Thomas Fritzel will no longer serve as Developer’s Representative to the City under the Redevelopment Agreement. The Developer’s Representative will be one of the new co-managers of Developer and the City will have the right to approve the person selected to serve as Developer Representative to the City.
- (2) The amount that the City is obligated to reimburse the Developer for certain infrastructure improvements under the Redevelopment Agreement is reduced from \$11,000,000.00, plus interest, to \$8,500,000.00, plus interest. Accordingly, the amount that the City is obligated to reimburse the Developer has been reduced by approximately \$2,500,000.00.
- (3) Under the original Redevelopment Agreement, the City would share equally with the Developer all TIF funds and would receive all TDD funds once the City had reimbursed the amount of \$7,100,000.00 to the Developer. Under the reformed Redevelopment Agreement, that amount has been reduced to \$5,750,000.00. In other words, the City will begin to share in tax proceeds from the Redevelopment District much earlier than it otherwise would under the original Redevelopment Agreement.
- (4) The new management of the Developer shall inform the City Manager of all new commercial entities relocating into the Redevelopment District. In no case shall any affiliate of Thomas Fritzel be permitted in the Redevelopment District without the prior written consent of the City.

(5) Annually, on November 1 of each year, the City shall have the right to audit all sales tax records of all commercial entities in the Redevelopment District for the preceding year and the Developer shall pay the costs of such audits.

(6) Annually, on November 1 of each year, the new management of the Developer will certify to the City, under penalty of law, that its sales tax returns for the preceding year are materially accurate and that all sales tax reimbursements made to it as a result thereof are likewise materially accurate.

(7) The Developer -- except in certain instances involving death, estate planning, or the sale of individual, residential condominiums -- is prohibited from transferring any ownership rights or other rights in the Oread Inn Hotel without the prior written consent of the City.

(8) Any violation of the foregoing or any violation of any residual terms of the original Redevelopment Agreement shall be deemed a default and the City shall have the right to demand that the Developer cure the default. If said default is not cured to the satisfaction of the City, then the City may take whatever legal recourse is necessary to cure the default, including termination of the reformed Redevelopment Agreement.

How much longer does the redevelopment agreement stay in place?

The term of the original Redevelopment Agreement was – unless terminated earlier on other grounds – until April 8, 2028, which is twenty years from the date of approval of the Project Plan, which was April 8, 2008, or once the City had reimbursed the Developer the sum of \$11,000,000 plus interest, whichever occurred earlier. The reformed Redevelopment Agreement will be in effect – unless terminated earlier on other grounds -- until April 8, 2028, or until the City reimburses the Developer the sum of \$8,500,000 plus interest, whichever occurs earlier.

What happens now with the 12th & Oread TIF and TDD districts?

Under the reformed Redevelopment Agreement, the City will continue to honor its agreement with the new management of the Developer under the reformed Redevelopment Agreement and shall, so long as all terms and conditions of the reformed Redevelopment Agreement are met, continue to reimburse to the Developer certain sales taxes and property taxes collected in the Redevelopment District. However, under the reformed Redevelopment Agreement, the City has enhanced oversight and remedial powers to deter, detect, thwart, and remedy any transgressions of the reformed Redevelopment Agreement.

How much cost has the City incurred by filing the Oread lawsuit and who paid those costs?

The City incurred the costs of the services of an accounting firm and a litigation firm. Since March of 2015, through March 31, 2017, the City has paid a total of \$178,280 for these firms' services.

How can we be sure this won't happen again?

If the settlement agreement is approved, Oread Wholesale and all wholesale, storage, distribution, warehousing, and procurement uses will be prohibited from operating in the Redevelopment District.

There will also be a change of managers in Oread Inn, L.C. Those changes, together with enhanced oversight provisions, including annual audits, at the Developer's expense, of the sales tax reimbursements, will provide greater protections to the City in the future. Moreover, the City's vigorous actions in response to the perceived improprieties by this Developer should motivate other developers, receiving incentives from the City, to adhere to the terms and conditions of their respective agreements. Furthermore, as a result of the City's experience with the Oread Inn TIF and TDD district, the City has modified its public incentives policies and performance agreements to deter similar behavior in the future.

Are there problems with other TIF or TDD districts?

Staff reviewed other TIF and TDD districts and did not note irregularities similar to those in the Oread Inn TIF and TDD Districts. We will continue to monitor them going forward.

Does this mean that the Oread Hotel is closing?

Nothing under this proposed settlement will require the closure of the Oread Hotel. The City feels that the revised Redevelopment Agreement will not negatively affect the economic viability of the Hotel going forward.

What happens to Oread Wholesale?

According to the terms of the proposed settlement agreement, Oread Wholesale will not be able to operate within the 12th & Oread TIF District during the period the redevelopment agreement is in place.

Are there any criminal penalties involved?

The proposed settlement relates only to the City's civil action against the Developer. In a civil lawsuit, juries generally only consider whether a party is legally responsible for monetary damages and the amount of monetary damages to be awarded. In a civil action, the standard of proof is a preponderance of the evidence, *i.e.*, the plaintiff must prove that its case is more probably true than not true. Because of the lower standard of proof, no criminal penalties may be assessed in a civil action. In fact, no criminal penalties may be assessed against any person until there is (1) a criminal investigation, (2) a determination by a prosecutor or grand jury that probable cause exists for a criminal indictment, and (3) the prosecuting attorney proves beyond a reasonable doubt that criminal conduct occurred. Those decisions reside beyond the purview of the City.