



NEW YORK CITY COMPTROLLER
BRAD LANDER

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Deputy Comptroller for Audit

Audit Report on the New York City Educational Construction Fund's Oversight of Its Lease Agreements with the East 57th Street Project

FN21-078A | October 13, 2022



THE CITY OF NEW YORK
OFFICE OF THE COMPTROLLER
BRAD LANDER

October 13, 2022

To the Residents of the City of New York,

My office has conducted an audit to determine whether the Educational Construction Fund (ECF) had adequate oversight over the development project at 250 East 57th Street. This audit examined whether lessees complied with the leases and other relevant agreements, whether they paid ECF in accordance with the terms of the Lease Agreements, and whether Payments in Lieu of Tax (PILOT) amounts charged to the lessees were assessed correctly. The Office of the New York City Comptroller conducts audits of City agencies and private entities doing business with the City as a means of increasing accountability and ensuring that City resources are used effectively, efficiently and in the best interest of the public.

The audit found that although ECF generally had adequate oversight over the lessees' compliance with the Lease Agreements and that the lessees generally paid ECF in accordance with the terms of the Lease Agreements, ECF verbally extended payment deadlines to the lessees, and then did not enforce them. ECF did not assess or collect \$30,346 in associated late fees for 43 condo sales where payments were received two to 15 days beyond the extended deadlines. In this respect, ECF did not fully safeguard the City's financial interests.

The audit recommends that ECF enforce all terms and conditions in the interests of the City and collect \$30,346 in late fees from Snowplow LH LLC, an affiliate of the site developer.

The results of the audit have been discussed with ECF officials, and their comments have been considered in the preparation of this report. ECF's complete written responses are attached to this report.

If you have any questions concerning this report, please e-mail my Audit Bureau at audit@comptroller.nyc.gov.

Sincerely,

A handwritten signature in black ink, appearing to read "B. Lander".

Brad Lander
New York City Comptroller

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AUDIT IMPACT

Summary of Findings

The audit found that the Educational Construction Fund (ECF) generally had adequate oversight over the lessees' compliance with the Ground Leases, the Residential Condominium Section Ancillary Agreement (RCS Agreement), and the Recurring Revenue Ancillary Agreement (collectively, Lease Agreements) and that the project's lessees generally paid ECF in accordance with the lease terms. However, the financial interests of the City of New York (the City) were not fully safeguarded because ECF waived \$30,346 in late fees that were legitimately due and owing.

To address the issue, the auditors recommended ECF enforce all terms and conditions in the interests of the City and collect \$30,346 in late fees.

Intended Benefits

The audit assessed the adequacy of ECF's oversight pertaining to its lease agreements for the East 57th Street project and determined certain payments should be collected in the best interest of the City.

INTRODUCTION

Background

ECF is a public benefit corporation created by the New York State Legislature in 1967. The mission of ECF is to build safe and secure learning environments for the New York City Department of Education (DOE) using land conveyed by the City, to increase the number of seats within the City's school system, and to provide comprehensive neighborhood development through the inclusion of commercial and/or residential components in its projects.¹

As a financing and development vehicle of DOE, ECF finances the school facility portions of mixed-use projects through ECF-issued tax-exempt bonds, which are backed by the City with terms of up to 40 years. ECF enters into development and ground lease agreements with developers for its projects and uses ground rents, lease payments, and/or tax equivalency payments from the non-school portion of projects to finance the construction of its school facilities.

Lease Agreement History with East 57th Street Project

On May 13, 2008, ECF entered into a development agreement and the Original Ground Lease with 250 East 57th Street, LLC (the Developer) to replace the school facilities that were located at 250 East 57th Street in Manhattan with a mixed-use facility, which would consist of a primary school, a high school complex, retail space, and a residential tower.²

On December 27, 2013, Snowplow LH LLC (Snowplow LH), an affiliate of the Developer, assumed all rights, titles, interest, and obligations under the Original Ground Lease; however, ECF continued to retain ownership of the land which encompasses the combined-occupancy project. ECF extended the lease term to 99 years with an option to further extend the lease to 125 years.

On the same date, the Original Ground Lease was divided into two ground leases:

- Ground Lease #1, governing a retail unit (Premises A); and
- Ground Lease #2, governing a residential tower and six retail units (Premises B).³

After completion of the construction, Snowplow LH submitted its leasehold interest under Ground Lease #2 to the provisions of the Condominium Act and established a regime for the condominium ownership of that leasehold interest, the property which consists of retail spaces and a residential tower at Premises B, and which was designated 252 Condominium (Condominium). One year later, on March 9, 2018, Aalto Owner (DE) LLC (Aalto) assumed Ground Lease #1 and acquired a portion of the interests and obligations in Ground Lease #2 from Snowplow LH.⁴

¹ School construction projects that do not have commercial and residential components are handled by the New York City School Construction Authority.

² Per the Original Ground Lease, the non-school portions of the mixed-used facility (i.e., retail space and residential tower) will be leased to the Developer for 75 years after the Stabilization Date (i.e., May 1, 2015).

³ The residential tower at Premises B contains 95 condominiums, 169 rental apartments, and six retail units.

⁴ Aalto acquired the interest of the six retail units and 169 rental apartments in Premises B.

Lessee Payment Requirements

The Lessee(s) of Ground Lease #1 are required to pay ECF:

- a monthly fixed rent, in advance on/before the 12th day of each month;
- an annual 4% of the gross rental income in excess of the threshold established in Lease #1 (Ground Lease Participation payment); and
- semi-annual tax equivalency payments, also known as Payments in Lieu of Taxes (PILOTs), as additional rent.⁵

The Lessee(s) of Ground Lease #2 are required to pay ECF:

- a monthly fixed rent, in advance, on/before the 12th day of each month;
- an annual 4% of the gross rental income in excess of the thresholds established for (1) the retail units, and (2) the rental apartments (Ground Lease Participation payment);⁶
- semi-annual PILOTs as additional rents; and
- 12.5% of the Gross Sales Price (Condo Share payments) for each condominium unit sold above the threshold established.⁷

For Fiscal Year 2020, ECF received a total of \$399,055 in lease payments for Ground Lease #1, and \$8,597,321 for Ground Lease #2.

Objectives

The objectives of this audit were to determine whether:

- ECF had adequate oversight over the lessees' compliance with the leases and other relevant agreements;
- Lessees paid ECF in accordance with the terms of the Lease Agreements associated with the East 57th Street project; and
- PILOT amounts charged to the lessees were equal to the actual real estate tax amounts and that, if the PILOT amounts were less than the actual real property tax amounts, the lower PILOTs were approved and justified.

⁵ According to the *New York State Exemption Administration Manual* Part 1: Municipal Governments, Section 4.03 – ED L Section 468: NYC Education Construction Fund: It states that real property that is used for the construction and/or improvement of elementary and secondary school buildings in combination with other compatible non-school purposes is wholly exempt from taxation, but liable for special assessments. Payments in lieu of taxes are required to be provided for in leases and subleases of non-school portions of any combined occupancy structures.

⁶ Per Section 2.1 of the Recurring Revenue Ancillary Agreement that is associated with Ground Lease #2.

⁷ Per Section 2.1 of the Residential Condominium Section Ancillary Agreement, a related agreement associated with the condominium portion of Premises B.

Discussion of Audit Results with ECF

The matters covered in this report were discussed with ECF officials during and at the conclusion of this audit. An Exit Conference Summary was sent to ECF on July 22, 2022 and discussed with ECF officials at an exit conference held on August 4, 2022. On September 19, 2022, we submitted a Draft Report to ECF with a request for written comments. We received a written response from ECF on September 29, 2022. In its response, ECF disagreed with the audit's determination that ECF did not assess or collect \$30,346 in associated late fees. After a careful review of the records, the auditors have concluded that changes to the findings are not warranted.

The full text of the ECF's response is included as an addendum to this report.

DETAILED FINDINGS

The audit found that ECF generally had adequate oversight over the lessees' compliance with the Lease Agreements and that the lessees generally paid ECF in accordance with the terms of the Lease Agreements. Specifically, ECF:

- properly recorded all lease payments from the lessees in its general ledger;
- ensured that the lessees paid the appropriate rent or PILOT amounts and that these payments were generally made on time;
- ensured that the lessees submitted the required financial reports; and
- ensured that the bonus floor area was appropriately obtained by creating affordable housing through participation in the Voluntary Inclusionary Housing Program and that the reduced PILOT amounts were justified.⁸

However, the auditors found that ECF did not assess or collect \$30,346 in associated late fees for 43 condo sales whose payments were received two to 15 days late. In waiving late fees that were legitimately due and owing, ECF did not fully safeguard the City's financial interests.

This issue is discussed in detail below.

ECF Voluntarily Waived \$30,346 in Late Fees

ECF did not assess or collect \$30,346 in late fees associated with the sale of 43 condo units after the modified deadline. Although ECF extended the Condo Share payment deadline from 10 days after the sale of a condo unit to four to six weeks after the closing months' end "for the ease of administration," there were 43 instances where Snowplow LH made the Condo Share payments more than six weeks after the closing month's end. ECF indicated that it did not collect the late fees because it had a verbal modification of the payment terms which provided that the Condo Share payments be made "monthly in the aggregate for all the unit closings within the month." However, the auditors' comparison of the modified payment due dates (four to six weeks) to the actual dates the payments were received found 43 instances where the payments were made between two to 15 days beyond the extended due dates. In waiving late fees that were legitimately due and owing, ECF did not fully safeguard the City's financial interests.

⁸ Bonus floor area is the additional square footage allowed to be built in exchange for the provision of a public amenity or affordable housing.

RECOMMENDATION

To address the detailed finding, the auditors recommend that ECF:

1. Enforce all terms and conditions in the interests of the City and collect \$30,346 in late fees from Snowplow LH.

ECF Response: ECF disagreed with the audit's determination, stating that "[a]t the time of the oral modification noted in the Draft Report, the Ground Lease #2 tenant paid a lump sum payment to ECF for its share of the sales prices for the first 29 condominium unit sales, without the payment of any late charges and without the demand for the payment of late charges. This evidences the parties' agreement that no late charges were to be imposed for those closings.

"As ECF and the Ground Lease #2 tenant relied upon their mutual verbal modification to alter the payment terms and acted in furtherance of and consistent with such verbal modification to complete the agreement, such modification would be deemed valid."

Auditor Response: According to ECF, the oral modification extended the due dates for Condo Share payments from within 10 days of the closing to as much as six weeks after the closing month's end. However, the auditors found that in 43 instances, Snowplow LH failed to make payment within the new deadlines set by ECF. The determination that \$30,346 in late fees were due to the City is only for payments made after the extended deadlines provided by ECF.

Recommendation Follow-up

Follow-up will be conducted periodically to determine the implementation status of each recommendation contained in this report. Status updates are reported in the Audit Recommendations Tracker available here: <https://comptroller.nyc.gov/services/for-the-public/audit/audit-recommendations-tracker/>

SCOPE AND METHODOLOGY

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. This audit was conducted in accordance with the audit responsibilities of the City Comptroller as set forth in Chapter 5, §93, of the New York City Charter.

This scope of this audit was July 1, 2017, through December 31, 2021. To obtain an understanding of ECF's policies and procedures regarding the administration of leases, the auditors reviewed ECF's Bylaws, Billing/Cash Receipts Procedures, and the excerpts of the following policies and procedures: Accounts Payable, Procurement, Debt Service Accounts, Reports to the New York City Office of Management and Budget, Annual Report, and Annual Administrative Budget. In addition, the auditors obtained and reviewed the leases and other agreements associated with the East 57th Street project, including but not limited to the Lease Agreement and the subsequent amendments, Ground Lease #1, Ground Lease #2, Development Agreement and the subsequent amendments, Declaration of 252 Condominium, Assignment and Assumption Agreement for Ground Lease #1, RCS Agreement, and Recurring Revenue Ancillary Agreement.

The auditors also interviewed ECF's Executive Director, external legal counsel, Director of Finance, and Staff Accountant. To obtain clarification of the lessees' relationship and payment responsibilities among the lessees and their management agents, the auditors interviewed the staff of the lessees and their designated property management companies.

In addition, the auditors reviewed the *New York State Exemption Administration Manual – Part 1: Municipal Governments Section 4.03 – Education Law Section 468*, to obtain an understanding of the real property tax exemption criteria for ECF projects. To determine whether the PILOTs established in each lease were equal to the real property taxes that should be charged without the ECF exemption, the auditors compared the amounts listed in Exhibit E of each lease to the real estate tax information that was available on the Department of Finance's website. The auditors then determined the amount of loss during the scope period, if lesser amounts were listed in the leases.

To determine whether ECF properly billed the lessees for fixed rent and PILOTs in accordance with the lease terms, the auditors obtained ECF's general ledger pertinent to the East 57th Street project. The auditors then recalculated the obligated fixed rent amounts, during the scope period, per the leases and compared them to the payments reported in ECF's general ledger. For the PILOT payments, the auditors compared the amounts ECF billed to the amounts recorded in ECF's general ledger.

To determine whether Snowplow LH paid ECF the appropriate amounts of Condo Share payments, the auditors obtained and reviewed the information of each of the 95 residential condominium unit sales provided by ECF. The auditors then recalculated the Condo Share payments using the sales information obtained from the Automated City Register Information System (ACRIS). The auditors also requested and reviewed the closing documentation for five of 46 condominiums that received a General Purchase Price Credit to determine whether credits that had been applied to the Condo Share payment calculations were deducted from the sales

prices of the condominiums. The auditors also traced ECF's Condo Share paid to the general ledger and assessed late charges, if applicable.

To determine whether the lessees accurately calculated and paid, if applicable, the 4% gross rental income in excess of the thresholds established in the Recurring Revenue Ancillary Agreement, the auditors judgmentally selected November 2020 as a sample.⁹ The auditors first reviewed the Rent Roll for the rental apartments and determined whether rent per total rentable square footage was accurately calculated. The auditors then compared the rent per each rentable square footage to the threshold established in the Recurring Revenue Ancillary Agreement. For the rent collected from the retail units, the auditors reviewed the amounts of rent collected from the subtenants and compared the amounts listed in the subleases. The auditors then determined whether the rent collected per square feet exceeded the threshold established in Ground Lease#1 and the Recurring Revenue Ancillary Agreement.

To determine the total number of rental apartments within Premises B and the occupancy status, the auditors conducted a physical walkthrough of the building on October 27, 2021, and compared with the rental apartments listed in the September 2021 Rent Roll. During the walkthrough, the auditors also observed the occupancy status of all retail units in both Premises A and B.

To determine whether the bonus floor area was appropriately obtained, the auditors visited the Department of Housing Preservation and Development's website for Inclusionary Housing Sites and identified the sites that were providing offsite affordable housing associated with the East 57th Street project.

Although the results of the sampling tests were not projectable to their respective populations, these results, together with the results of the other audit procedures and tests, provided a reasonable basis for the audit team to evaluate and to support the findings and conclusions within the context of the audit objectives.

⁹ November 2020 was selected as the sample month because it was the most recent and complete rent roll available at the time the auditors conducted the test.



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September 29, 2022

Maura Hayes-Chaffe, Deputy Comptroller for Audit
Office of the New York City Comptroller, Audit Bureau **by Electronic Mail**

Re: Draft Audit Report on the New York City Educational Construction Fund's Oversight of Its Lease Agreements with the East 57th Street Project, dated September 19, 2022 (Comptroller #: FN21-078A)

Dear Ms. Hayes-Chaffe:

We write on behalf of the New York City Educational Construction Fund ("ECF") in response to the Draft Audit Report on the New York City Educational Construction Fund's Oversight of Its Lease Agreements with the East 57th Street Project, dated September 19, 2022 (the "Draft Report"). We offer for your consideration this written response to the Draft Report. We understand this response will be appended to the final report.

Summary of Findings and Recommendation

The Draft Report finds that "ECF did not assess nor collect \$30,346 in associated late fees for 43 condo sales whose payments were received 2 to 15 days late" and that ECF "waiv[ed] late fees that were legitimately due and owing." The Draft Report then recommends that ECF collect such \$30,346 in late fees.

ECF respectfully disagrees with this determination. For the sale of the residential condominium units, the governing document is the Residential Condominium Section Ancillary Agreement, which provides that ECF's share of condominium sales are first calculated when 25% of the square-footage of the residential condominium units has been sold. Most of the late fees calculated by the Comptroller's office come from the first 25% of condominium units sold. At the time of the oral modification noted in the Draft Report, the Ground Lease #2 tenant paid a lump sum payment to ECF for its share of the sales prices for the first 29 condominium unit sales, without the payment of any late charges and without the demand for the payment of late charges. This evidences the parties' agreement that no late charges were to be imposed for those closings.

As ECF and the Ground Lease #2 tenant relied upon their mutual verbal modification to alter the payment terms and acted in furtherance of and consistent with such verbal modification to complete the agreement, such modification would be deemed valid.

Thank you for your consideration of these issues. Please feel free to contact us with any additional questions.

Sincerely,

Jennifer Maldonado
Chief Executive Officer

c: Rachel Reardon, Faige Hornung, Amy Man, Vanessa Rodriguez-Colon, Josefina Soto

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Bronx, New York
- Primary School 205
Bronx, New York
- Early Childhood Center
Bronx, New York
- Early Childhood Center
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