



California Department of Veterans Affairs and Department of General Services

The Departments' Mismanagement of the Veterans Home Properties Has Not Served the Veterans' Best Interests and Has Been Detrimental to the State

January 2019

REPORT 2018-112





CALIFORNIA STATE AUDITOR

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January 29, 2019

2018-112

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the California State Auditor presents this audit report concerning California Department of Veterans Affairs (CalVet) and Department of General Services' (DGS) leases and other third-party uses of veterans home property. CalVet operates eight veterans homes across the State that provide residential and medical care to eligible veterans. State law authorizes DGS, with CalVet's consent, to lease property at the homes to third parties so long as the lease terms are in the homes' best interests.

This report concludes that CalVet and DGS entered into agreements with third parties that are inconsistent with the homes' best interests and that violate state law by allowing the third parties to lease property for decades. Although state law requires that the funds from veterans home leases supplement the funding that the homes receive, DGS and CalVet failed to ensure that \$610,000 was appropriately directed to the homes. Additionally, DGS could not explain how it had established the rental rates for most of the leases we reviewed, and the rates for two leases are far below the current market rent. Finally, CalVet allowed some third parties to occupy veterans home property without written agreements to protect the State from liability, without charging rent that could have been used to benefit the homes, and without DGS approval.

Because of these significant issues, we determined that CalVet and DGS should define what constitutes the best interests of the veterans homes and deny any uses that are inconsistent with those interests. We also recommend that DGS set rental rates equivalent to market rent, and that both CalVet and DGS ensure that the proceeds from leases are directed to the veterans homes. Finally, CalVet should evict the entities occupying space without a lease or work with DGS to establish leases for them.

Respectfully submitted,

A handwritten signature in black ink that reads "Elaine M. Howle". The signature is written in a cursive, flowing style.

ELAINE M. HOWLE, CPA
California State Auditor

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SUMMARY

The California Department of Veterans Affairs (CalVet) oversees eight veterans homes throughout the State that provide rehabilitative, residential, and medical care to eligible veterans residing in California. State law authorizes the Department of General Services (DGS), with CalVet's consent, to lease property not immediately needed at the veterans homes to third parties so long as the lease terms are in the best interests of the home. CalVet and DGS have entered into a number of leases, including leases for a theater, museum, and golf course, most of them at the Yountville veterans home (Yountville). We reviewed active leases of the veterans home properties as well as the processes of CalVet and DGS for setting and collecting lease payments and monitoring compliance with the terms of those leases. We also reviewed CalVet's process for permitting short-term uses of veterans home property by third parties, such as for fun runs and cycling events. This report draws the following conclusions:

CalVet and DGS Mismanaged Veterans Home Property by Entering Into Agreements That Do Not Align With State Law or the Interests of the Veteran Residents

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CalVet and DGS have entered into leases without ensuring that they were in the best interests of Yountville and that do not comply with state law. In fact, neither department had developed criteria for determining whether a lease is in the best interests of a veterans home. CalVet has also permitted four entities to occupy space at Yountville without written agreements to protect the State from liability and without compensating the home. Additionally, CalVet's failure to adequately oversee state-owned employee housing (employee housing) at Yountville has resulted in leases that expose the State to liability. Finally, despite a history of questionable leases of veterans home properties, CalVet did not implement policies and procedures to ensure that leases comply with state law.

CalVet and DGS Have Inadequately Overseen Rental Fees and Payments, Reducing the Funds Collected and Reinvested for the Benefit of the Veteran Residents

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DGS cannot demonstrate that the State received appropriate value for leases of state property because it did not document market value assessments before establishing rental rates for those leases. Further, CalVet and DGS have not ensured that the rental revenue that they do collect has been directed to the veterans homes as required by state law, and CalVet has failed to collect all of the rent owed to it by lessees. In total over the last three fiscal years, CalVet and DGS

have not ensured that \$610,000 in rent was directed to the veterans homes. CalVet also failed to regularly assess the fair market rent for employee housing at Yountville, resulting in a \$152,000 gap in 2018 between the current rents and the fair market rent.

Page 43**CalVet's Poor Oversight of the Veterans Home Properties Has Exposed the State to Risk and Caused CalVet to Forgo Revenue That Would Have Benefited Veterans**

CalVet allowed third parties to host a variety of events at the veterans homes, such as cycling events and fun runs, sometimes without obtaining written agreements to protect the State against liability. CalVet also allowed some third parties to use the properties without compensating the homes, forgoing revenue that could have been used to benefit veterans. Furthermore, CalVet has failed to monitor compliance with the terms of its leases. In one instance, a lessee had entered into a contract allowing a company to launch hot air balloons daily from a veterans home property in violation of its lease terms. Although CalVet has been aware of this activity for two years, it has not acted to stop it.

Summary of Recommendations***Legislature***

The Legislature should amend state law to do the following:

- Require CalVet to define what types of short-term uses of veterans home properties are in the best interests of the home and to include in all short-term use agreements conditions that protect the State's interests.
- Prohibit CalVet from approving any short-term uses of the veterans home properties that do not meet the best interests of the home.

CalVet

CalVet should do the following:

- Implement policies for ensuring that leases of veterans home properties comply with state law.
- Report all lease proceeds to the Legislature and request appropriation of those funds to the veterans homes.
- Revise its employee housing leases to include terms that protect the State and ensure that rental rates for its employee housing units are consistent with the market rates.

DGS

DGS should adopt, in consultation with CalVet, a definition of what constitutes the best interests of the veterans homes and deny any requests for leases that do not meet those criteria.

DGS should document its assessment of market value on all veterans home properties before leasing the property and set rental rates equivalent to market rent.

DGS should report the lease proceeds it collects to the appropriate authorities to ensure that the proceeds are directed to the veterans homes.

Agency Comments

CalVet agreed with or stated that it would implement all of our recommendations. DGS generally agreed with most of our recommendations, but disagreed that it should collect payments for all leases of veterans home property.

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INTRODUCTION

The California Veterans Homes

The California Department of Veterans Affairs (CalVet) oversees eight veterans homes across the State. The homes provide rehabilitative, residential, and medical services to the veterans who reside there. Veterans who are disabled or over 55 years of age and a resident of California are eligible to apply for admission to the homes. Each home provides different levels of care, including skilled nursing care and memory care. The homes also range in size. For example, the Lancaster home can house 60 residents on a 20-acre site while the largest home, the Yountville home (Yountville) in Napa County, can house up to 1,000 residents on a site that covers several hundred acres. A governor-appointed administrator manages the day-to-day operations of each home and reports to CalVet headquarters.

California Veterans Home Sites

- Barstow
- Chula Vista
- Fresno
- Lancaster
- Redding
- Ventura
- West Los Angeles
- Yountville

Source: CalVet.

Leases of Veterans Home Properties

Under state law, the Department of General Services (DGS) has general authority to lease state-owned real property, including veterans home properties, with the consent of the agency responsible for the property. It has specific authority to lease a veterans home property as long as the property is not needed for any direct or immediate purpose and the terms and conditions of the lease are in the best interests of the home. As shown in Table 1 on the following page, DGS and CalVet have leased out a variety of spaces at the homes, the majority of which are at Yountville. Figure 1 on page 7 shows the locations of the leases at Yountville. Some of these leases are for land only, upon which the lessee then constructs one or more buildings to suit its needs, and others are for existing facilities or office spaces. In addition to leases, CalVet and DGS have entered into other agreements permitting third parties to occupy space at the homes for extended periods of time. The scope of our review encompassed all agreements active as of June 2018 that CalVet and DGS entered into that gave a third party the right to occupy a portion of a veterans home property in exchange for some form of rent, services, or improvements to the property. Although not all of these agreements are technically leases, for the sake of simplicity in this report we refer to all such agreements as *leases*.

Table 1
Third Parties Have Leased Property at Some of the Veterans Homes

USE OF LEASED PROPERTY	LEASE EFFECTIVE DATE	LEASE DURATION	ANNUAL RENT DUE FOR FISCAL YEAR 2017-18	RATE OF ANNUAL RENT INCREASE DURING LEASE DURATION	LESSEE'S RENEWAL TERM OPTIONS
Chula Vista					
Telecommunication facility	July 1, 2012	10 years	\$47,564	5%	Two 5-year options
Automated teller machine (ATM)	August 1, 2015	5 years	\$600	—	—
Fresno					
Barber-beauty shop	June 1, 2016	5 years	\$965*	—	—
Yountville					
Napa Valley Museum	November 7, 1988	32 years	\$7,348	5%	One 20-year option
Firefighter training facility	May 1, 1997	25 years	None—waived provided CalVet remains in an agreement for emergency and fire services	—	Two 4-year options
Fire station	July 1, 1997	25 years	None—waived provided CalVet remains in an agreement for emergency and fire services	—	Two 4-year options
Golf course	February 10, 1998	30 years	\$115,483	—†	Three 10-year options
Convenience store	November 4, 1998	Indefinite	\$27,000	—	—
Swimming pool	May 28, 2005	20 years	\$1	—	Indefinite number of 10-year options
Barber-beauty shop‡	January 1, 2012	5 years	\$996	5%	—
Storage units‡	October 1, 2012	5 years	\$16,994	5%	—
Lincoln Theater	November 6, 2012	10 years	\$20,000	—	One 5-year option§
ATM	November 1, 2013	5 years	\$1,200	—	—
Post office	August 1, 2014	5 years	None—lessee maintains the building in place of rent	—	—
Barber-beauty shop	August 1, 2015	5 years	\$1,015	\$60	—
ATM	July 1, 2016	5 years	\$300	—	—
Baseball field	November 1, 2016	5 years	\$4,133	5%	—
Tug McGraw offices and garden	August 1, 2017	1 year	\$3,557	—	—
The Pathway Home mental health facility	January 1, 2018	5 years	None—lessee provides mental health services to nonresident veterans in place of rent	—	—

Source: Review of CalVet's veterans homes leases.

■ = Leases selected for review

* As discussed later in the report, this rent amount is based on percentage of sales; however, CalVet did not collect the records necessary to determine the actual rent owed.

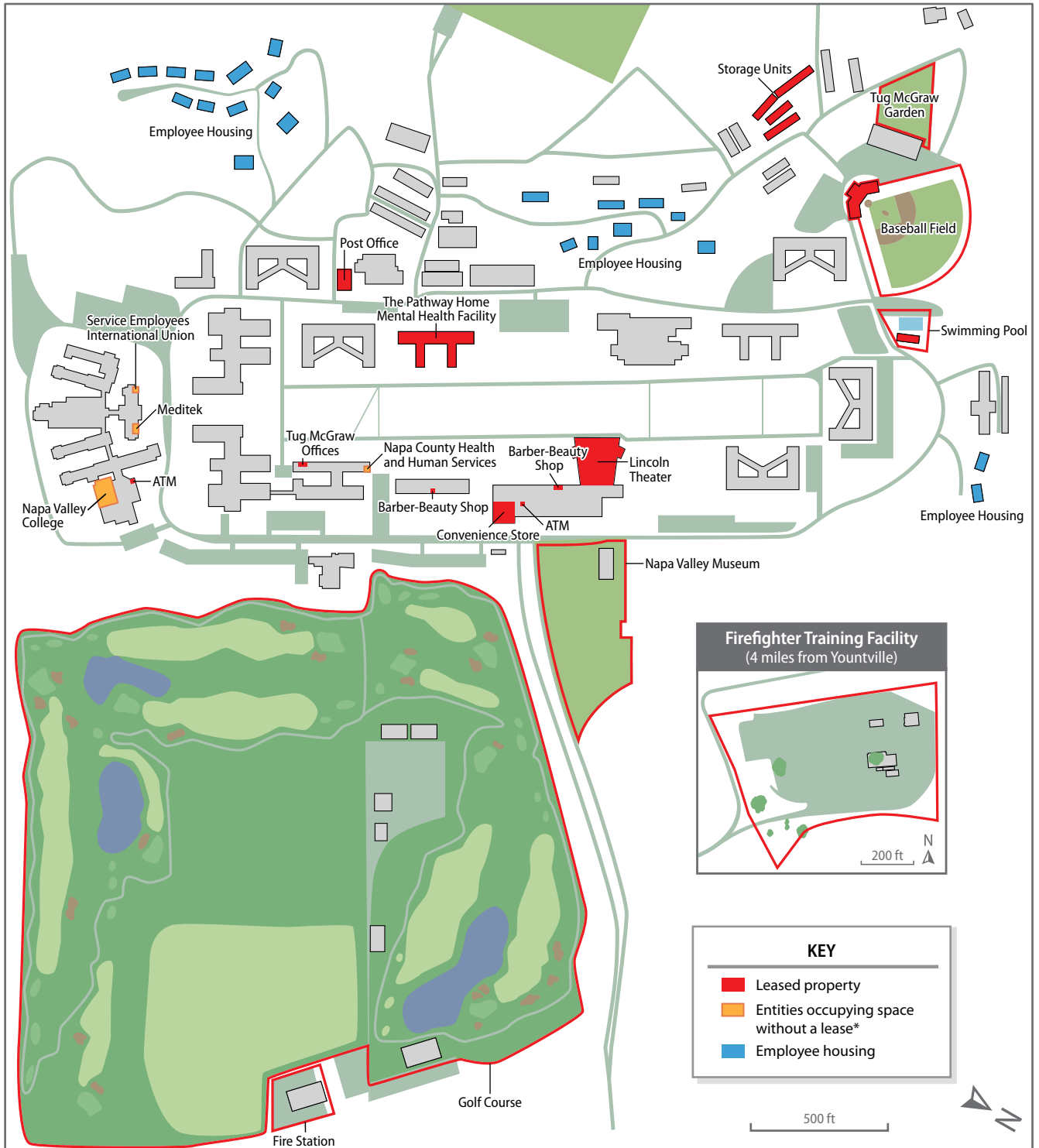
† The minimum annual rent varies during the lease's 30-year term. However, from 2018 until the end of the initial lease term, the minimum annual rent does not increase.

‡ Although these agreements have expired, the lessee continues to occupy the property.

§ Unlike the other leases, the Lincoln Theater lessee may only renew its lease for five years if both the State and the lessee agree.

|| CalVet and The Pathway Home mutually agreed to end the lease effective August 31, 2018.

Figure 1
There Are Many Leased Spaces at the Yountville Veterans Home



Source: Analysis of the uses of the Yountville property and map provided by CalVet.

* We discuss the entities occupying space without a lease in the first section of our report.

State law and DGS policy prescribe the requirements for leasing state property. DGS's policy requires that agencies, including CalVet, submit a written request to DGS to develop a lease. The request must include a description of the benefits of the lease to the State, including consideration of the agency's scope and mission, and the broad public benefit. DGS's policy provides that, for veterans home properties, this requirement can be met by a description of the benefit the lease would provide to veterans. Under DGS policy, the lease should specify the rental fee for the property, which state law generally requires to be set at fair market rent—in other words, the most probable rent that a lessee would pay in an open market. Once the terms of the lease are established, DGS, CalVet, and the lessee sign the lease.

Rental fees from the leasing of veterans home properties must contribute to the funding of the homes, but they are not a significant source of revenue. General support for the homes comes predominantly from the State's General Fund, from which the homes received more than \$310 million in fiscal year 2017–18. However, the State is reimbursed for some of the costs of the homes by funding that CalVet receives from various sources—including the U.S. Department of Veterans Affairs (USDVA), Medicare, and fees that the residents pay to reside in the homes. Combined, these revenues provided about \$107 million in funding in fiscal year 2017–18. State law requires that the proceeds from most leases of veterans home properties be deposited into the General Fund to augment the appropriation that the homes receive. In fiscal year 2017–18, those proceeds totaled \$174,000. However, as we describe in our report, neither DGS nor CalVet have ensured that all lease revenue is directed back to the veterans homes.

State law also requires that the proceeds from a home's base exchange convenience store (convenience store), golf course green fees and ball fees, and proceeds from other activities unique to each home, be deposited into the morale, welfare, and recreation operating fund (morale fund) specific to each home. As the name suggests, the money in these funds may be used to administer quality-of-life activities for the veteran residents. For example, the funding can be used for entertainment expenses, sports activities, and celebrations. Much of the revenue that the morale funds receive is generated from cost-of-care fees collected from the estates of deceased veteran residents. The balance for the Yountville home's morale fund at the end of fiscal year 2017–18 was \$4.2 million. In that year, the Yountville morale fund received just over \$16,300 from the operation of its convenience store. However, as we discuss later, it should have received more.

Yountville also has state-owned employee housing (employee housing) where CalVet leases housing units to the home's employees. Of the current 25 housing units—built between 1920 and 1955—only 19 are habitable. The remaining units require significant renovation. According to CalVet's housing records, as of July 5, 2018, 15 of the 19 units were occupied. CalVet's November 2018 housing policy outlines criteria for employee housing and assigns priority first to employees in positions that it deems critical for or supportive of the continuity of operations during emergency situations at the home, then to employees in positions that are difficult to recruit or that have high turnover. The remaining housing units are then available to all other eligible employees of the home. The law requires the California Department of Human Resources (CalHR) to issue rules for administration of employee housing throughout the State. All state agencies, including CalVet, are required by state law to comply with CalHR's employee housing rules.

CalVet has received criticism over its management of uses of veterans home properties. In October 2013, our office issued an investigative report in which we found that CalVet had executed two imprudent leases on behalf of Yountville that violated state leasing requirements, including failing to obtain DGS approval, failing to obtain fair market rent for the leased property, and leasing the property for longer than five years. In January 2014, the Department of Finance criticized CalVet for failing to obtain DGS approval when it entered certain leases and for failing to monitor and enforce compliance with lease payments. As we discuss later in this report, we identified some of the same issues in our review of the active leases of the Yountville property. Although unrelated to CalVet, the USDVA experienced similar criticism when in 2011 it was sued for authorizing uses of its West Los Angeles campus—which is adjacent to CalVet's West Los Angeles veterans home—that did not directly contribute to the operation of a home for disabled veterans.

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CalVet and DGS Mismanaged Veterans Home Property by Entering Into Agreements That Do Not Align With State Law or the Interests of the Veteran Residents

Key Points

- CalVet and DGS have not ensured that leases of veterans home property are in the best interests of the home. Four leases we reviewed are in effect for longer than state law allows and one lease is void because CalVet entered into it without DGS approval.
- CalVet has allowed four entities to occupy veterans home property without a written agreement and without collecting rent, exposing the State to greater risk of liability and missing an opportunity to collect revenue that could be used to support the home.
- Most of the leases for employee housing that we reviewed lacked key terms protecting the State's interests, such as terms protecting the State against liability.
- Despite previous problems with third-party use of veterans home property, CalVet has failed to implement policies and procedures to ensure that leases comply with state law.

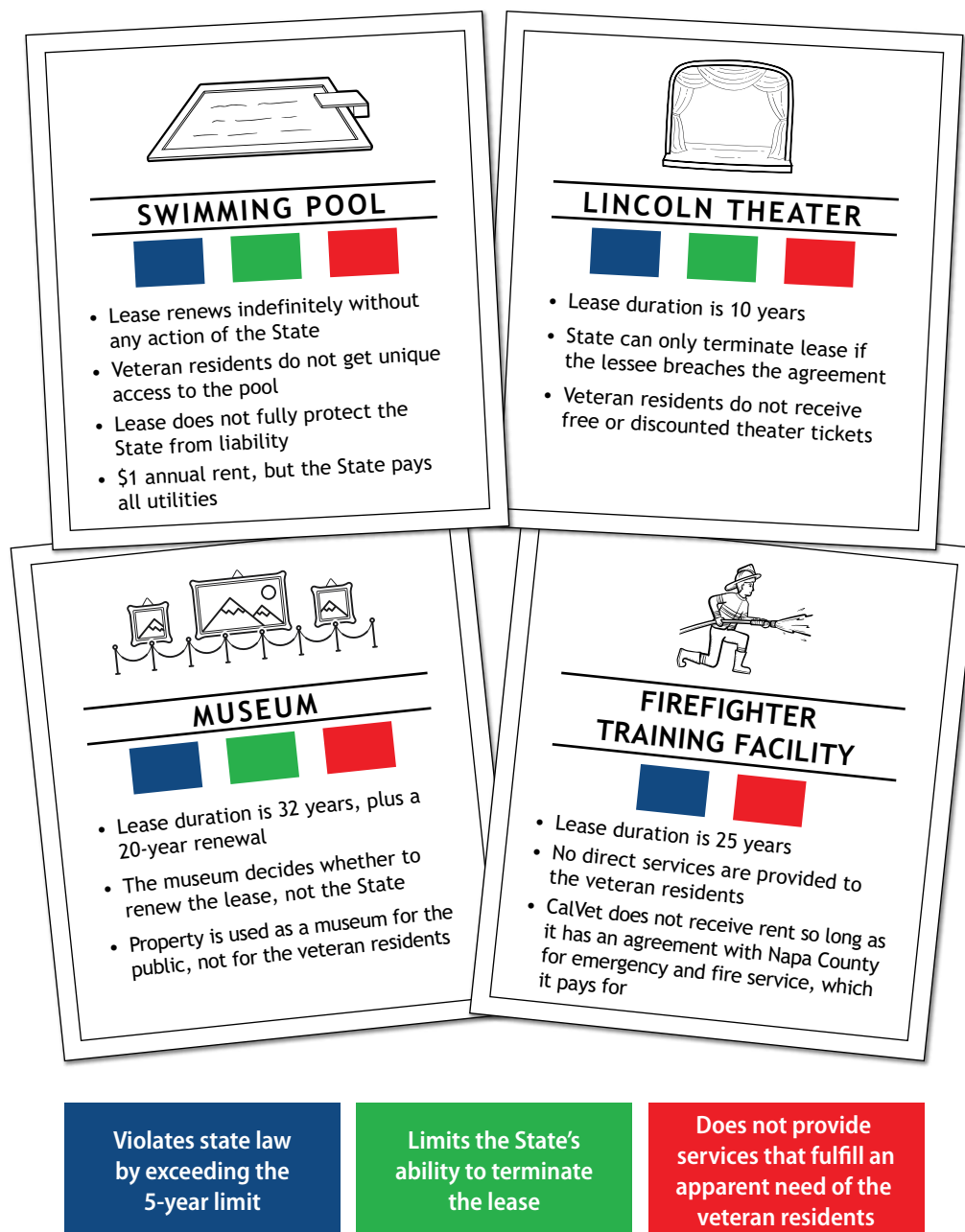
CalVet and DGS Established Agreements of Questionable Benefit to the Veteran Residents and With Unfavorable Terms

Some of the leases of Yountville property do not appear to be in the best interests of the home. State law authorizes DGS to lease veterans home property to any entity or person under terms and conditions that are in the best interests of the home. However, neither CalVet nor DGS had defined how they would determine whether lease agreements were in *the best interests of the home*; therefore they had no consistent criteria to ensure that leases complied with that statutory requirement. Without such a definition, it is questionable whether certain leases at Yountville are in the home's best interests. For example, although some of the leases provide services that fulfill needs of the veteran residents—such as the leases for the post office, barber and beauty services, and the convenience store—other leases do not provide a comparable benefit. These include the leases for the museum and the golf course, among others. CalVet agreed with us that some of the 11 leases we reviewed, which were entered between November 1988 and January 2018, provide little to no direct benefit to the home or its residents. Figure 2 on the following page contains examples of select leases and terms that make us question the benefit to the home. For example, although it provides residents convenient access to the performing arts, the operating agreement for the Lincoln Theater does not provide them with free or

reduced price tickets to shows. Instead, during fiscal years 2015–16 through 2017–18, Yountville paid more than \$65,000 for the residents to attend shows, which is more than the \$60,000 in rent that the theater owed to the home over the same period.

Figure 2

We Question Whether Some of the Leases Are in the Best Interests of the Yountville Veterans Home



In response to our concerns that some of the leases did not appear to be in the best interests of the veterans homes, DGS pointed to certain benefits that some of the leases provide, such as the residents' ability to visit the museum for free. However, the presence of one or more benefits does not necessarily mean that a lease is consistent with the best interests of the home. In order to make such a determination, DGS should have documented consideration of all of the benefits of a given lease as well as the drawbacks, such as the length of time that the property would be committed in the lease or the potential disruption that a lease might cause the residents. Its documented consideration could then have included weighing the benefits and drawbacks against criteria for what it means for a lease to be in the best interests of the veterans home. However, we found no evidence that DGS documented any such analysis before approving the leases we reviewed.

Without a definition or any criteria for determining whether a lease of veterans home property is in the best interests of the home, DGS is not able to act in the oversight role that state law assigns to it. State law gives DGS the authority to lease state-owned property if it determines that doing so is in the best interests of the State. According to the chief of DGS's real estate leasing and planning section (chief of state-owned leasing), DGS's current practice for leasing state-owned property is to use its master template, which contains terms and conditions that are in the best interests of the State, such as terms allowing the State to enter the property to inspect it and requiring the lessee to obtain insurance. We found that DGS had used this template for some of the more recent leases of the veterans home properties. However, even though the chief of state-owned leasing noted that staff have been instructed to use the template, DGS does not have an explicit policy that requires its use.

Moreover, state law establishes an additional requirement specific to leases of veterans home properties: the terms and conditions of such leases must be in the best interests of the home. Because this criterion encompasses a consideration of the veteran residents' needs, it would be prudent for DGS to collaborate with CalVet to define what constitutes the best interests of the home. DGS has specialized knowledge of the leasing of state-owned property and therefore is best positioned to define the terms and conditions necessary for protecting the home's and the State's financial or legal interests. CalVet's expertise lies in its knowledge of the needs of the homes and their residents. In other words, CalVet can more appropriately comment on how a potential lease would affect the lives of residents and the day-to-day operations of a home. In fact, in response to our audit, in December 2018 CalVet distributed a property use policy to its veterans home administrators that defines what property uses CalVet considers to be in the best interests of its homes.

CalVet and DGS also established leases that are longer than state law allows. State law generally limits the length of lease terms to no more than five years, with specified exceptions. In general, the State can benefit from keeping lease periods shorter because shorter leases reduce the time that state property is obligated to other purposes and they give the State the opportunity to reexamine the benefit of lease arrangements more frequently. However, of the 10 leases we reviewed that both agencies were involved in establishing, four exceeded the five-year term limit without a statutory exception. The longest lease term among these leases will reach 60 years if the lessee exercises all of its options to extend the agreement. Among these four leases are those for the theater, museum, and golf course at Yountville, which are in effect for up to 15, 52, and 60 years, respectively. These leases are of particular concern because they do not contain provisions that allow the State to terminate the agreements at its discretion but only upon breach of the lease terms by the lessee. This arrangement is more restrictive than terms we observed in other leases that allow for cancellation of the lease agreement by either party without giving a reason, provided there is notice within a prescribed amount of time. Further, narrow termination provisions exacerbate the problems created by the long duration of these leases, making it difficult for the State to end the leases early without litigation.

.....

The lease provisions for the theater, museum, and golf course at Yountville do not allow the State to terminate the agreements at its discretion but only upon breach of the lease terms by the lessee.

.....

DGS believes that it has the authority to lease veterans home property for periods of time that are longer than five years, but we disagree. Two key provisions of state law govern DGS's authority to lease veterans home property. One is a general authority granted to DGS to lease state-owned property, which contains the requirement we discussed earlier: that leases cannot exceed five years in length. The other provision of state law, which DGS believes authorizes it to exceed the five-year limit when leasing veterans home property, specifies that DGS has the authority to lease veterans home property provided that the terms of the lease are in the best interests of the veterans home, but it is silent as to the length of the lease. DGS's chief of state-owned leasing explained that because the terms of a lease include the period of time for which it is valid,

this provision of law allows DGS to lease veterans home property for more than five years. We disagree with this interpretation of the law. The provision of law concerning all leases of state property is applicable to leases of veterans home property. If the Legislature intended to exempt veterans home leases from the five-year duration limit, it would have specified that exemption in state law. Further, as we state earlier, DGS has not defined what constitutes the best interests of the veterans home, which makes us question how DGS ever could have made a determination that the extended lease durations were in the best interests of Yountville.

DGS has not defined what constitutes the best interests of the veterans home.

The deputy director of real estate services at DGS (deputy director) further argued that it is unclear whether the laws governing leasing of veterans home properties—which include the requirement that the lease be in the best interests of the home and the prohibition on the length of time the lease can span—apply to the Lincoln Theater agreement because that agreement is not a lease but rather an operating agreement. It is true that the agreement states that it does not provide any right of ownership or leasehold, but as we discuss below, it contains a number of provisions that limit the rights of the State in a manner similar to a lease. However, the deputy director also acknowledged that state law does not establish a framework for departments to enter operating agreements. Instead, he stated that CalVet and DGS had two options to solicit an operator for the theater: a contract for services or a lease of property.

The agreement with the operator of the Lincoln Theater contains provisions resembling a lease rather than a contract for services. First, rather than paying a third party to operate the Lincoln Theater—as would occur in a services contract—the agreement allows the Lincoln Theater lessee to use the veterans home property in exchange for rent. Also, the agreement does not provide for free use of the theater by CalVet. Instead, the Lincoln Theater lessee charges the home to use the theater, such as for the veterans' holiday concert. Such an arrangement seems to contradict the statement in the agreement that says no right of ownership is conveyed because the operator can restrict CalVet's presence in the theater building. Finally, the agreement states that it is entered into under the section of state law that gives DGS authority to lease veterans home property and DGS processed the agreement through its state-owned leasing division, not its procurement division.

These facts indicate that DGS also perceived the agreement as a lease and not a contract for services. The chief of state-owned leasing generally agreed that if DGS were to establish an agreement for the theater today, it would use a lease. DGS and CalVet should not avoid the requirements in state law that govern leases by renaming the agreement and inserting a statement that the agreement is not a lease. Because of these factors, we believe that the agreement for the Lincoln Theater should have conformed to the requirements applicable to leases, including the five-year maximum term.

Finally, one lease we reviewed was not approved by DGS and exposes the State to liability. State law requires DGS approval of every agreement that conveys any interest in real property owned by the State, unless the Legislature specifically provides otherwise. Any such agreement executed without DGS approval is void. However, CalVet leased the Yountville home's swimming pool to the town of Yountville without DGS approval. DGS's leasing manager agreed that the lease required DGS approval and is a voidable document. CalVet's assistant deputy secretary of the veterans homes division at the time we conducted our audit (CalVet's assistant deputy) did not occupy his position at the time this agreement was signed by CalVet and therefore could not explain why CalVet entered into a lease without DGS approval. He agreed that it would be beneficial to reassess the lease to ensure its compliance with state law. Additionally, the pool agreement does not explicitly protect the State from liability for accidental harm to people or property. Because of this limitation on the State's protection from liability, the State is at a greater risk for liability than it would be if CalVet had used language similar to the language in DGS's lease template, which protects the State from liability for all harm to people or property occurring on the leased property. CalVet's assistant deputy acknowledged that CalVet did not ensure that this language was included in the lease. As we discuss later, until this audit CalVet lacked policies and procedures for leasing veterans home properties. This lack of policies and procedures likely contributed to CalVet's failure to adhere to state requirements.

CalVet Allowed Four Entities to Occupy Space at Yountville Without Protecting the State Against Liability and Without Compensating the Home

CalVet exposed the State to risk by allowing four entities—as shown in the text box—to occupy space at Yountville without lease agreements. As it did with the swimming pool agreement we discussed in the previous section, CalVet permitted these four entities to occupy space at the home without DGS approval. Of further concern is that CalVet does not have written agreements with the four entities for the use of the space. By allowing entities to occupy space without written lease agreements, CalVet has exposed the State to financial

and legal risks that would otherwise be mitigated by written agreements that indemnified the State from liability or that required the tenants to obtain insurance. One of the property users, Napa Valley College, operates a nurse training facility within Yountville's hospital building. Without an agreement that defines the limits of the State's liability, the State is at a higher than necessary risk of being found liable if, for example, a nurse trainee were injured on the property. DGS's involvement in decisions about the use of state property is critical because its role is to ensure that the State's interests are protected in its contracts with other entities. If CalVet had sought a written agreement for these uses of this veterans home property and received the required approvals for such agreements, it could have avoided exposing the State to unnecessary risk.

Four Entities Occupy Space Without a Written Agreement

- Napa Valley College
- Service Employees International Union (SEIU)
- Meditek, a medical equipment repair business
- Napa County Health and Human Services

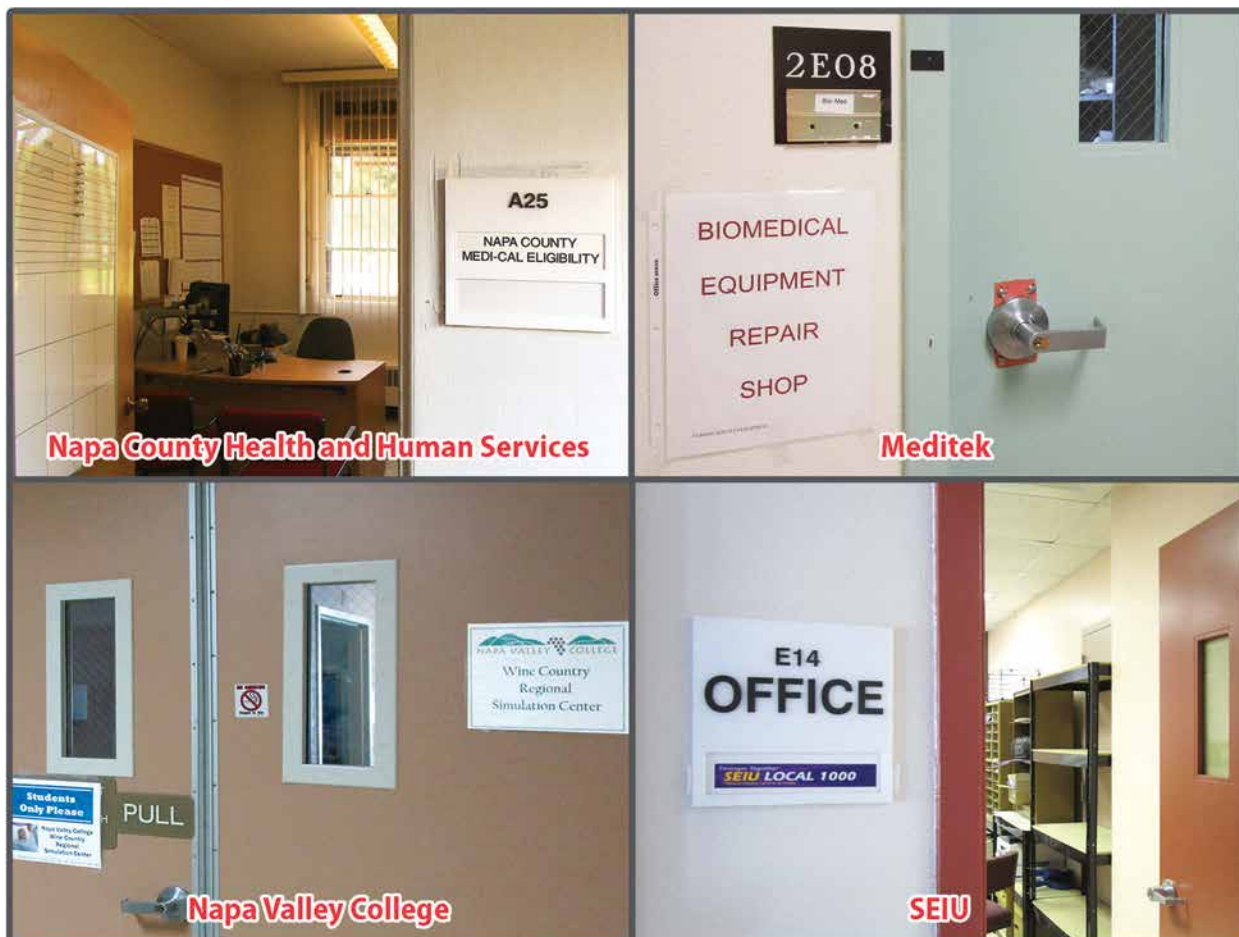
Source: Auditor observation and CalVet.

Further, CalVet permitted these entities to use space without paying rent and therefore missed an opportunity to collect rental fees that could be used to support the veterans home. The most significant of these four cases is Napa Valley College. No one we spoke with at CalVet could explain why Yountville permitted the college to occupy that space. However, based on records we found at Yountville, in the late 1980s, the former home administrator entered into a memorandum of understanding (MOU) with Napa Valley College to provide space at the home for a health occupation program. This MOU did not establish a fee for the use of the veterans home's space. The records we reviewed indicate that Napa Valley College's last active MOU expired in June 2012, but the college has continued to occupy the space without a written agreement and without paying rent. In July 2005, Napa Valley College obtained an estimate of the rental value of the space that it occupies from a commercial real estate company, which estimated the value at about \$90,500 per year. Given that estimate, even if it were to determine that there was justification for charging below-market rent for the space used by the college, CalVet has forgone a significant amount of revenue that could have been used to support the veterans home. According to CalVet's assistant deputy, he has not found any evidence that Napa Valley College's use of the space benefits the home, and he believes the home would benefit more if the space were used for home staff offices, which he stated are in short supply.

According to CalVet's assistant deputy, until recently no one at CalVet headquarters was aware that these four entities occupied space at the veterans home and headquarters learned about the occupancy only when he personally inspected the property in anticipation of our office's audit and observed the four entities in the spaces. CalVet's lack of awareness of these uses of the veterans home property is consistent with its distant approach to

managing the property at its homes. As shown in Figure 3, these entities have posted signs signaling their presence, and documents in Yountville’s files indicate that Napa Valley College has occupied space for almost 30 years. Stronger oversight and monitoring by CalVet could have ensured that it quickly identified unsanctioned uses of its property and either pursued written agreements that guard against liability or removed the unpermitted entities from its premises. Further, CalVet’s weak oversight has resulted in forgone revenue that it could have invested in the home.

Figure 3
Four Entities Occupied Space at Yountville Without Written Lease Agreements



Source: Auditor observation during a tour of Yountville and correspondence with CalVet staff.

After we raised our concerns with CalVet, its assistant deputy stated that headquarters is reviewing the four entities’ use of the space to determine their benefit to the home, and it has requested a lease from DGS for the office that Napa County Health and Human

Services occupies. According to CalVet's assistant deputy, this office provides a direct benefit to the veteran residents because it helps them obtain Medi-Cal benefits.

CalVet Did Not Provide Adequate Oversight of Yountville's State-Owned Housing Program, Exposing the State to Risk and Allowing Employees to Abuse Their Authority

CalVet did not provide adequate oversight of the state-owned employee housing leases at Yountville, and therefore the leases do not adhere to key requirements that protect the State's interests. State law requires CalHR to determine the fair and reasonable value of lodging that the State provides to its employees (employee housing) and to provide, by rule, instruction to state agencies for the administration of employee housing. State law also requires each state department that possesses employee housing to comply with CalHR's employee housing rules. CalHR has developed requirements for employee housing leases, including specific terms and conditions that must be written into all such leases. These terms protect the State's interests and include an indemnification clause to hold the State harmless against claims, damages, or other injury by the lessee as a result of living on the premises; the terms also require proof of homeowner and liability insurance, among other conditions. However, as shown in Figure 4 on the following page, the majority of the employee housing leases we reviewed lacked several key terms and therefore did not sufficiently protect the State's interests or adequately shield the State from potential liability.

According to CalVet's assistant deputy, the leases lack key terms because CalVet's headquarters did not oversee the employee housing. However, CalVet's legal counsel stated that he informed CalVet as early as 2013 that Yountville's employee housing leases had several significant legal issues. Yet CalVet did not take action to remedy those problematic housing leases or more directly manage Yountville's employee housing. Instead, it deferred responsibility for managing employee housing to the Yountville home. In fact, until recently, a housing committee made up of Yountville employees managed the housing, including reviewing and approving requests for housing, drafting and implementing housing documents without CalVet's approval, and signing leases on behalf of CalVet. No one at CalVet headquarters could explain when or why CalVet deferred responsibility for employee housing to the housing committee. Yountville's housing leases are binding agreements that obligate the State and tenant employees to meet certain responsibilities. That CalVet would defer management of these agreements to a committee of veterans home staff with no oversight from CalVet headquarters is puzzling. This deference and lack of oversight significantly increased the State's risk of liability.

Figure 4
Yountville's Employee Housing Leases Do Not Adequately Protect the State From Legal and Financial Liability



Source: Analysis of 10 judgmentally selected Yountville employee housing leases.

In addition, the employee housing committee created the appearance of impropriety in its housing decisions. CalVet's employee housing committee policy stated that the housing committee was responsible for reviewing housing requests and making recommendations to the Yountville administrator, who approved or denied the committee's recommendations. Despite the requirement for administrator review, the committee created the appearance of favoritism and improper decision-making. Three members of the committee lived in employee housing at the time they served on the committee. Further, the housing committee made decisions that directly benefited committee members,

such as recommending that the home administrator approve the sitting housing committee chairperson's request for housing and recommending that two members, including the chairperson, be assigned "priority" housing status. This status granted these employees preference in receiving an employee housing unit and allowed the employees to lease a unit for the duration of their employment. These examples highlight the potential for perceived inequity resulting from CalVet's lack of oversight of the housing committee. Although these issues do not directly violate the state requirements related to employee housing, they compromise the perceived fairness of CalVet's employee housing program.

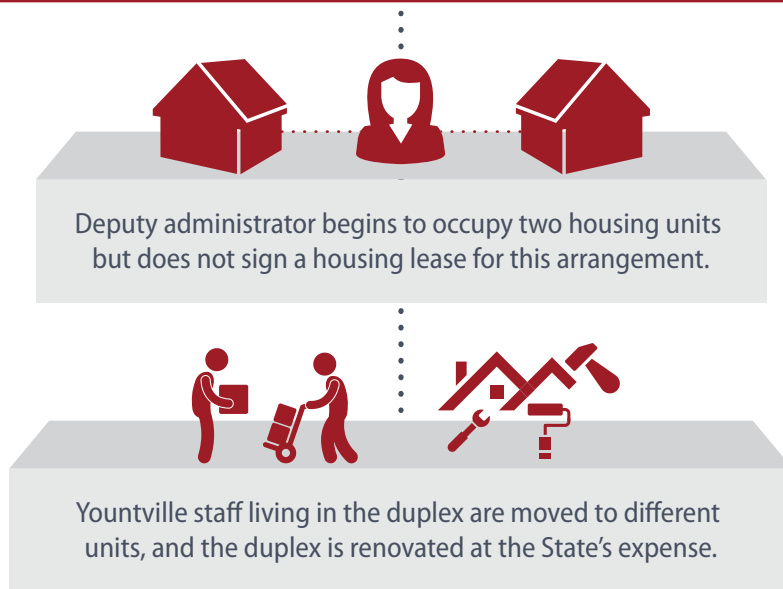
Furthermore, because CalVet did not adequately oversee employee housing, two employees who were charged with that oversight—a former deputy administrator (deputy administrator) and the former state asset manager (state asset manager)—used their positions to receive inappropriate housing benefits. According to a former chairperson of the housing committee, sometime in late 2016 the deputy administrator at Yountville assumed responsibility for making decisions about employee housing. Around that time, she moved into two separate units while having a duplex renovated at the State's expense to accommodate her immediate family. We summarize the deputy administrator's housing situation—which was approved by the then home administrator—in Figure 5 on the following page. According to CalVet's assistant deputy, CalVet headquarters was unaware of this arrangement at the time the home administrator approved it.

In September 2017, CalVet hired a state asset manager to manage the leased properties at Yountville, including employee housing. He also used his position to gain inappropriate housing benefits. In December 2017, the state asset manager submitted a proposal to the deputy administrator requesting permission to occupy an employee housing unit, and he later requested a rental rate of \$300 per month—\$275 less than CalVet had determined the rent for that unit should be—in exchange for making improvements to the unit. In mid-December he notified staff at the home that he would begin occupying the housing unit immediately. The state asset manager never signed a lease and did not pay rent for about six months. He stated that he did not view the lack of a signed lease as a problem because he did not plan to stay in the home for the long term. It is likely that the deputy administrator knew that the state asset manager was occupying the unit because that unit was immediately next door to one of the housing units she lived in. Therefore, the deputy administrator allowed this inappropriate housing arrangement, failing to adequately oversee the Yountville property. CalVet headquarters' lack of awareness and oversight of the employees responsible for managing Yountville's employee housing allowed these employees to abuse their positions for personal gain, further undermining the fairness and integrity of employee housing at Yountville.

Figure 5**Yountville's Deputy Administrator Used Her Position to Receive Inappropriate Housing Benefits**

Yountville deputy administrator requests inappropriate housing benefits, including the following:

- Simultaneously occupying two houses.
- Paying a rental rate about \$300 below fair market value.
- Renovating a separate housing duplex for her family.



On May 15, 2018, CalVet headquarters prohibited home administrators from approving employee housing leases.

That evening the deputy administrator directed the state asset manager to develop a lease formalizing her questionable housing arrangement and had him backdate the lease to May 1, 2018, which was before CalVet's prohibition.

The resulting lease established a rental rate that was below fair market value by \$800 per month.

Source: Review of CalVet's employee housing records and correspondence.

Note: The deputy administrator and state asset manager no longer work at CalVet.

In April 2018, in anticipation of our audit, staff at CalVet headquarters began reviewing employee housing arrangements and discovered the deputy administrator's and state asset manager's inappropriate arrangements. Both individuals were subsequently terminated. According to legal counsel at CalVet, CalVet does not intend to take any further action against either former employee, including recovering unpaid rent, because it is unclear how CalVet would do so without valid leases.

CalVet headquarters has assumed control of employee housing at Yountville and has taken steps to correct the problems we identified with employee housing. In May 2018, CalVet issued a directive to the eight veterans homes administrators stating that headquarters was taking control of the leases of veterans home properties, including employee housing leases. Additionally, in July 2018, CalVet headquarters approved one of the 10 employee housing leases we reviewed, which its legal staff developed. This lease is for the current administrator's housing unit and contains most of the key terms we identified as needed to protect the interests of the State. Furthermore, CalVet approved a housing policy in November 2018 that adopts CalHR policy as CalVet policy and states that CalVet headquarters will be responsible for key employee housing functions, including approving leases. Direct management and oversight over employee housing by headquarters will better ensure that employee housing is administered fairly and that housing leases comply with state policy and protect the interests of the State.

CalVet's Failure to Implement Adequate Leasing Processes Creates Risk That Future Agreements Will Not Protect the State Nor Veterans Homes' Interests

Despite previous problems with the leases of veterans home property, CalVet failed to implement policies and procedures to ensure that it established leases in accordance with law and regulation. In an investigative report our office issued in October 2013, we described CalVet's failure to monitor Yountville and oversee the Yountville administrator's activities. We reported that in the absence of CalVet supervision, the administrator entered into two contracts that violated state contracting requirements related to leasing state property. These contracts ultimately cost the State more than \$650,000. In light of these agreements, it would have been prudent for CalVet to prioritize implementing policies and procedures for the creation and approval of third-party uses of veterans home properties, including leasing. However, CalVet did not do so. At the outset of this audit, we requested CalVet's policies and procedures for leasing veterans home property, and CalVet's assistant deputy provided a policy that CalVet had approved in 2012. However, he stated that CalVet discovered this policy only after this audit

was requested and that it had never implemented the policy nor developed any other leasing policies between the publication of our October 2013 audit report and the beginning of this audit.

In early December 2018, CalVet distributed a policy to all veterans home administrators that was effective immediately related to the use of home properties, including leased uses. The policy establishes a set of criteria for determining what leases are in the best interests of the veterans homes, requires the secretary of CalVet or his or her designee to approve all leases on behalf of CalVet, and requires DGS's approval of all lease agreements. The policy also states that CalVet shall make a reasonable effort to establish the fair market value of property, but as we explain later, state law assigns responsibility for ensuring that state-owned property is leased for fair market rent to DGS. If implemented, CalVet's policy would address key concerns we have about the current leases of its property. However, this policy was introduced in the later stages of our audit and we do not yet have assurance that CalVet will follow its policy.

Further, DGS would benefit the State by reminding departments about its role in approving leases of state-owned property. As we indicated earlier, state law requires that any agreement that conveys an interest in state-owned property be approved by DGS. CalVet has entered into agreements for which it did not obtain DGS approval. One of those agreements involved the Yountville swimming pool, as discussed previously. Further, a Department of Finance audit from January 2014 noted that CalVet failed to obtain DGS approval of a lease for a barber-beauty shop. Finally, as we explained on the previous page, a Yountville administrator entered into leases that violated state leasing requirements. Both of these agreements required DGS approval, which CalVet did not obtain. These agreements, although they all stem from one department, indicate that the State would benefit from having DGS remind all state entities that manage state-owned property about their obligation to involve DGS before entering into agreements for the use of that property. According to DGS's leasing manager, the role DGS has related to leasing and contracting has historically been clear. However, he stated that DGS would issue a bulletin to departments to remind them about the roles and responsibilities for leasing state-owned property.

Recommendations

Legislature

To prevent future leases of veterans home property that obligate the property to third parties for unnecessarily extended periods of time, the Legislature should amend state law to clarify that leases of veterans home property may not exceed five years unless a statutory exception applies.

CalVet

To ensure that future leases of veterans home property are established in accordance with state requirements, CalVet should implement its property use policy when considering all proposed leases of veterans home property.

To ensure that it protects the State and the best interests of Yountville, by March 2019 CalVet should complete its review of the four entities that do not have leases and should begin either evicting the entities or obtaining lease agreements with them through DGS.

To ensure that its employee housing lease agreements are sufficient to protect the State, by June 2019 CalVet should revise its existing employee housing leases in accordance with the guidance CalHR has provided to agencies to protect the State's interests, including making sure that they include terms that fully indemnify the State against damages and require rental insurance.

To avoid the appearance of impropriety and ensure proper management of employee housing, CalVet should implement its new housing policy and ensure that employee housing decisions are made by its headquarters office in a clear and consistent manner.

DGS

To ensure that leases of veterans home property comply with state law and are consistent with the veterans homes' mission to serve the veteran residents, by June 2019 DGS should adopt, in consultation with CalVet, a definition of what constitutes the best interests of the veterans homes and begin incorporating that definition into the *State Administrative Manual*. DGS should deny any requests for leases that do not meet that standard. When leasing veterans home property, DGS should document its reasons for determining that the terms of the lease are in the best interests of the home.

To ensure that all leases of veterans home property protect the interests of the State and the homes, DGS should review the current lease that is void under state law and any that do not meet its criteria for being in the best interests of the veterans homes. DGS should attempt to reach new agreements with these lessees that address any areas of noncompliance and concern.

To remind state entities about the requirements for agreements that convey an interest in state property, by June 2019 DGS should issue guidance about its approval authority for such agreements.

CalVet and DGS Have Inadequately Overseen Rental Fees and Payments, Reducing the Funds Collected and Reinvested for the Benefit of the Veteran Residents

Key Points

- State law requires DGS to set rental rates at the fair market rent, but DGS cannot demonstrate how it established the rent for most of the properties we reviewed. In at least two cases, DGS set rental rates significantly below current market rent.
- CalVet did not adequately monitor lease payments or seek the augmentation to the appropriation for the veterans homes that it is owed under state law and DGS deposited lease revenue in the wrong fund. Combined, these errors resulted in \$610,000 that was not appropriated to the veterans homes from fiscal years 2015–16 through 2017–18.
- CalVet did not ensure that employee housing rental rates were consistent with the market, which resulted in forgone revenue, including a \$152,000 gap in 2018 between current rental rates and fair market rent.

DGS Cannot Support the Rental Rates It Approved for Most of the Leases of Veterans Home Properties We Reviewed

DGS cannot show how it ensured that the State received appropriate rental fees for most of the 10 leases we reviewed because it did not document fair market value assessments. Those 10 leases are listed in the text box. State law requires DGS to set rental rates for leases of state property at *fair market rent*. DGS policy states that it establishes fair market rent for state-owned property commensurate with the *fair market value* for the property, and considering property constraints. In July 2018, DGS formalized its process for determining fair market value. This process includes methods such as inspecting the property, comparing the site to similar locations in the surrounding market, and applying the professional judgment of the DGS leasing officer. However, DGS could not demonstrate how it established the fair market value of seven of the 10 properties whose leases we reviewed and that DGS approved.

We Reviewed the Rental Rates of 10 Leases

1. Baseball field
2. Fire station
3. Firefighter training facility
4. Golf course
5. Lincoln Theater
6. Napa Valley Museum
7. Storage units
8. Telecommunication facility
9. The Pathway Home mental health facility
10. Tug McGraw offices and garden

Source: Review of CalVet's veterans homes' leases.

In response to our concerns that DGS could not show how it established the fair market value of these seven properties, DGS's chief of state-owned leasing said that, in practice, DGS generally uses three methods to assess the fair market value of state-owned property: formal appraisals, competitive bidding, and referencing the fair market value of similar properties and making any necessary adjustments. However, we found no evidence that DGS used these methods to determine fair market value for any of the seven properties. The chief of state-owned leasing indicated that formal appraisals are the most costly of the three methods and is the method DGS uses least often. He also stated that DGS did not competitively bid six of the seven leases because those leases were exempt from competitive bidding requirements, which we found to be true. In the final case, he said that DGS did not competitively bid the storage unit lease because it believed CalVet had done so. Finally, he explained that because each situation is different, it is not always possible to generalize from one lease to another to establish a fair market value.

.....

DGS could not demonstrate how it established rental rates for seven of the 10 properties whose leases we reviewed and that DGS approved.

.....

We acknowledge that formal appraisals may at times be cost-prohibitive, that sometimes leases are exempt from competitive bidding requirements, and that some properties may be unique and difficult to compare to other properties. However, competitive bidding, even when not required, could have helped DGS determine both the demand for the properties and the rental rate that tenants were willing to pay. DGS could not support with documentation the rental rates it set for the seven properties. Therefore, it is not clear how it determined these rates. The rent charged to these tenants has a direct effect on the amount of funding available to the veterans homes, because state law requires that most money received in connection with leasing of veterans home properties should augment the appropriation made to the homes. In other words, the lease revenue should provide additional funding for the maintenance and operation of the veterans homes, including activities related to the care of the veteran residents.

DGS has also set rental rates that include discounts for services or improvements to the property that lessees provide, but it has no calculation of the value of those contributions. DGS's leasing

policy allows lessees to receive a reduction in rent commensurate with any direct benefit that they provide the State so long as the benefit is fully documented. DGS used this provision to waive the rent for four of the leases that were active at Yountville as of June 30, 2018: the post office, fire station, firefighter training facility, and The Pathway Home. Under these circumstances, we expected that DGS would have calculated the value of the benefit that the lessee provides and then reduced the rent by that calculated value. However, in none of those four cases did it document how it determined that those services or improvements warranted reducing the full rent amount.

Because DGS did not document the value lessees provided and because it did not document its fair market value assessments of these properties—which would have established a starting point from which to deduct the value—DGS cannot support its decision to waive rent. The post office lease, which began in August 2014, provides an obvious direct service to the veterans at the home, but DGS waived its rent of \$900 per month because the lessee agreed to maintain the building in good repair. Determining the estimated monthly maintenance costs of the leased space and documenting its analysis to demonstrate the value the lease agreement provides are reasonable steps that DGS should have taken but did not.

.....

DGS did not document how it determined that services or improvements provided by the post office, fire station, firefighter training facility, and The Pathway Home lessees warranted reducing the full rent amount.

.....

In another example, Napa County has leased property at Yountville for a firefighter training facility since May 1997. Through means it cannot demonstrate, DGS established that the rental rate for the property was \$30,000 per year. DGS then waived the rental fee so long as CalVet remains a party to an agreement for emergency and firefighting services with Napa County. However, that services agreement also obligates CalVet to pay for those services, and in fiscal year 2017–18, the Napa County Fire Department charged CalVet \$730,000. Although such an arrangement might be reasonable if CalVet received a credit toward the fee it owed to Napa County, the invoices from Napa County that CalVet provided to us show no deduction in the amount CalVet owes to offset the \$30,000 rental value of the property Napa County leases.

Given that CalVet pays for services and receives no apparent credit for allowing Napa County to use its property, it is unclear why DGS approved an agreement that waived the rental fee. The lease was established before CalVet's assistant deputy came into his position, but his assessment was that the home receives no direct benefit from this lease. When DGS waives rental rates without determining the actual value of the improvements or services the lessee provides, it risks failing to collect funds that should be collected and used for the benefit of the veterans homes.

To better understand the potential loss of revenue to Yountville as a result of DGS's undocumented assessments of fair market value, we retained two certified real estate appraisers (appraisers) to assess the current fair market rent for three leased properties—the Napa Valley Museum, the Lincoln Theater, and the golf course. The results of those appraisals are shown in Table 2.¹ We found that DGS competitively bid the golf course property, and as the table illustrates, the golf course rental rate is fairly consistent with fair market rent for a golf course. However, the difference between the annual fair market rent of the museum property and the rent that CalVet actually collects is striking. Under the terms of its agreement, the lessee pays only to lease approximately four acres of land, on which the lessee built a museum building. Accordingly, we asked our appraiser to assess the market rental rate for the land that is the subject of the lease. Using the appraised value of the land as of November 1, 2018, we calculated that the payment the museum lessee made for fiscal year 2017–18 was less than 5 percent of the fair market rent for the property it leases.

It would be unreasonable to expect that in 1988—when DGS and CalVet signed the museum lease—DGS could have anticipated what the fair market rent of the property would be in 2018, 30 years later. However, we expected DGS to have documented its assessment of the fair market rent of the property before approving the lease. After doing so, in recognition of the length of the lease it was approving, DGS could have incorporated terms into the lease to allow periodic adjustment of the rental rate to keep it consistent with fair market rent. Additionally, the lease has a base term of 32 years and gives the museum lessee the option to extend the lease for an additional 20 years—without the need to obtain DGS's or CalVet's consent. DGS will not be able to reassess the rent payments for this property until the year 2040 if the museum lessee exercises its 20-year option.

¹ The market rental rates in the appraisals we obtained are based on lease durations that exceed the five-year limit under state law, and our appraisers stated that these durations are consistent with those that occur in the market for such leases. However, DGS would have to obtain authorization from the Legislature to enter leases with these durations.

Table 2
DGS Approved Annual Rental Rates That Are Inconsistent With Fair Market Rent for Two of Three Yountville Properties

PROPERTY	CURRENT FAIR MARKET RENT	ACTUAL RENT UNDER THE LEASE	DIFFERENCE
Museum	\$153,600	\$7,348	(\$146,252)
Lincoln Theater	91,200*	20,000	(71,200)
Golf Course	97,000†	115,483	18,483

Source: Analysis of leases for the museum, Lincoln Theater, and golf course, and market value and market rent appraisals that certified real estate appraisers completed on the museum land, Lincoln Theater, and golf course.

* This amount represents the fair market rent for the land upon which the theater is situated and does not include the theater building itself. According to the appraiser who assessed the theater, the fair market rent for the theater building and land is \$1.36 million per year. We explain why we excluded the theater building in the report text.

† This value is based on the value of the land for the sole use of a golf course. Our appraiser determined this was the highest and best use of the property.

Similarly, we question the appropriateness of the Lincoln Theater rental rate, but the unusual nature of the agreement with the theater lessee makes it difficult to determine the actual fair market rent that the veterans home should receive. According to our appraiser, the agreement that DGS and CalVet have with the theater is unusual because performing arts theater owners typically do not lease theaters to third parties. Instead, performing arts theaters are typically owner-occupied. However, using what he determined was the only applicable approach to calculating the market rent, our appraiser determined a reasonable market rent for the theater to be \$1.36 million per year. The market rent is based on the current appraised market value of the theater building and the land upon which the theater is situated. However, not all of the value of the theater building is due to the State's investment. The theater lessee agreed to make a financial investment toward the theater's renovation as part of the lessee's original agreement from 1997 with the State for the property. Because the renovation has already occurred and because the records we reviewed at DGS and CalVet related to this property did not include an appraisal of the property's value before the renovation, it is difficult to separate the value of the lessee's investment from the current value of the property to determine what the lessee should pay in rent after accounting for its investment. However, even if we consider only the fair market value of the land upon which the theater building resides and disregard the value of the theater building, the theater lessee still pays less than one-fourth of the \$91,200 fair market rent of the land. The Lincoln Theater agreement expires in November 2022 unless CalVet and the lessee mutually agree to exercise the option in the agreement to extend it for another five years at the current terms.

CalVet and DGS Failed to Ensure That Proceeds From Leases of Veterans Home Property Were Directed to the Benefit of the Veterans Homes

CalVet and DGS's mismanagement of lease proceeds denied the veterans homes funding that they were entitled to under state law, which CalVet could have used toward the operation of the homes. As stated previously, state law requires that the proceeds from most leases of veterans home properties be deposited into the General Fund to augment the appropriation that the homes receive. CalVet can then use these funds toward operating the homes, including activities related to the care of the veteran residents. As we discuss in the next section, both DGS and CalVet collect rental payments for the properties. Therefore, both have a responsibility to ensure that the homes receive the proceeds from leases of their property; however, neither did. As a result, the veterans homes did not receive a total of \$509,000 in lease revenue from July 2015 through June 2018.

CalVet did not act to ensure that the homes received the lease proceeds it collected. From July 2015 through June 2018, CalVet collected \$391,000 in lease payments that should have gone to the veterans homes. Although we found that CalVet deposited these lease proceeds into the General Fund, it did not then take appropriate action to notify the relevant authorities—the Department of Finance and the Legislature—that CalVet should receive those funds to augment the appropriation for the homes. According to CalVet's chief budget officer, she was unaware that the law required the homes to receive those funds, and she acknowledged that CalVet had not made an effort to notify the Department of Finance or the Legislature that CalVet should receive them. According to the assistant deputy, he became aware of the requirement when researching relevant law in preparation for our audit.

.....

CalVet had not made an effort to notify the Department of Finance or the Legislature that CalVet should receive the lease proceeds it collected to augment the appropriation for the homes.

.....

In response to our concerns that CalVet had never pursued this funding, the assistant deputy stated that he believes that section of law that requires lease proceeds to augment the appropriation to the homes is outdated. He pointed us to other sections of state law related to federal funding for veterans and noted that those sections

of the law use the same language as the lease revenue section; specifically they state that federal funding should augment the appropriation made to the veterans homes. Because of the identical phrasing in these sections of the law and because CalVet no longer receives federal funding as an augmentation to its appropriation, it was the assistant deputy's belief that the Legislature does not intend CalVet to receive lease revenue as an augmentation to its veterans home appropriation. However, he acknowledged that CalVet has never pursued revisions to state law to reflect this belief. Regardless of the assistant deputy's interpretation, state law explicitly states that the funds from leases of veterans home property must augment the appropriation made to the homes. We expected that CalVet would have taken proactive steps to obtain all of the funding to which the homes are entitled because these funds could support the operation of the homes and therefore benefit veteran residents.

**State law explicitly states that
the funds from leases of veterans
home property must augment the
appropriation made to the homes.**

Similarly, DGS did not ensure that the homes received the funds that it collected from leases of their property. We found that from July 2015 through June 2018, rather than depositing the almost \$118,000 in lease payments that it collected into the General Fund as required by law, DGS deposited the payments into the property acquisition law money fund. As a result, the funds were not available to augment the veterans homes appropriation. According to a DGS accounting administrator, DGS believed that making deposits to the property acquisition law money fund was in compliance with the law; however, after we informed DGS that state law mandates that lease payments related to veterans home property go to the General Fund, it agreed that it should deposit payments there.

**CalVet Failed to Properly Monitor and Enforce Rental Payments,
Reducing the Funds Available to Benefit the Veterans Homes and
Their Residents**

The responsibility for collecting lease payments for veterans home properties is split between CalVet and DGS. Because rental payments for employee housing are automatically deducted from employees' pay, we focused our review on payments for nonhousing leases. We reviewed the lease payments CalVet and DGS collected

for fiscal years 2015–16 through 2017–18 for 15 leases. In fiscal year 2017–18, CalVet was responsible for collecting payments for 12 of these leases.

We expected that CalVet would monitor the lease payments it receives to ensure that the lessees make all required payments, but it does not. The chief of the accounting division at CalVet (accounting chief) confirmed that CalVet’s accounting division does not know the specific amounts that lessees are responsible for paying. She also stated that the department lacks a policy or procedures for monitoring and enforcing lease payments. However, without knowing how much is due from lessees, the accounting division is unable to effectively monitor payments and ensure that it receives all of the money it is owed.

CalVet does not monitor the lease payments it receives to ensure that the lessees make all required payments.

CalVet’s accounting chief attributed the poor monitoring of lease payments to a lack of coordination between divisions. She stated that although the accounting division receives the rental payments sent to CalVet headquarters, until recently it was not notified when CalVet entered into a new lease nor did it receive a copy of the lease, and it did not know about new leases until it received a rental payment from a lessee. She also said that enforcing compliance with lease terms, which would include rental payments, was the responsibility of the veterans homes. However, we question this reasoning, because CalVet’s accounting division receives some of the lease payments and the homes send the division either payment records or the payments themselves for payments they receive. As a result, the division is better able than the homes to monitor lessee payments. CalVet’s accounting chief agreed that the division should be aware of when a lessee should submit lease payments and she stated that in June or July 2018 she had requested that the accounting division receive a copy of all new leases.

Poor monitoring of payments led CalVet to believe it had not received significant payments from one lessee. Specifically, CalVet’s accounting division was unaware that it had received *percentage rent* payments from the golf course lessee, which are known as such because the payments are based on a percentage of the golf course’s revenue or proceeds in certain sales categories, such as merchandise and food and beverages. From July 2015 through June 2018, CalVet’s

accounting division did not monitor the percentage rent payments. In fact, the accounting chief stated that the golf course had not paid the percentage rent to headquarters in many years because she believed the rent checks went to Yountville. However, among CalVet's records we found copies of checks from the golf course lessee for the percentage rent owed for the last three years of the lease agreement and evidence that CalVet had deposited the checks. The total value of these payments was \$67,000, or 14 percent of the total rent payments that CalVet collected for veterans home leases over the past three fiscal years. CalVet's lack of awareness that it had received those payments is troubling, and this instance makes us question the accuracy of its payment tracking records.

CalVet's lack of policies and procedures for payment enforcement likely contributed to another of our areas of concern: \$101,000 in unpaid rent over a three-year period. The leases for three tenants—a barber-beauty shop, a convenience store, and the golf course—establish the amount of rent due as a percentage of sales. We expected that CalVet would be collecting sufficient records from each of these lessees to calculate the amount each is required to pay and then ensure that the lessee made the correct rent payment. However, CalVet did not do so, and as a result, it has not collected the total amount of rent it is owed.

.....

CalVet's lack of policies and procedures for payment enforcement likely contributed to \$101,000 in unpaid rent over a three-year period.

.....

For the convenience store, CalVet received self-reported revenue and profit information from the lessee and relied upon the lessee's own calculation of rent owed instead of calculating the rent using the formula spelled out in the lease. We used the information the lessee provided to CalVet and determined that for the most recent three fiscal years, the lessee underpaid its rent by almost \$53,000, which is 76 percent of the total rent it owed during that period. Additionally, because CalVet did not have sales records from the golf course lessee that it could use to validate the rent owed under that lease, we obtained those records directly from the golf course lessee. We found that for the last three lease years, the lessee underpaid by almost \$48,000, or 42 percent of the percentage rent it owed. Finally, because CalVet collected sales records from the barber-beauty shop for only six of the 25 months the shop was open during our audit period, we could not determine whether the lessee had paid all rent it owed.

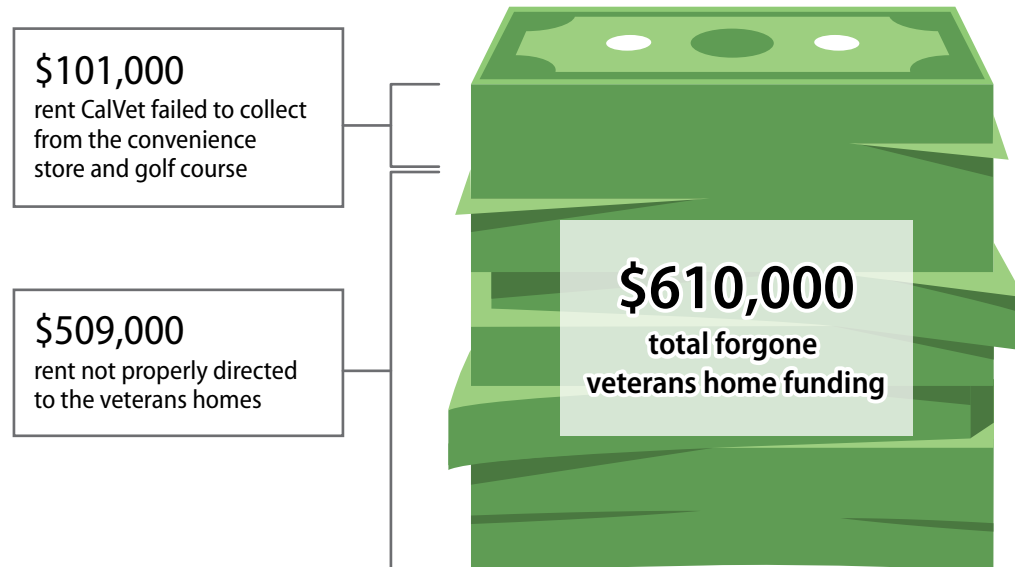
Because CalVet did not calculate or collect all of the rent owed by the convenience store and golf course lessees, less money has been available to support residents of Yountville. State law requires CalVet to deposit the proceeds from the operation of the convenience store into Yountville's morale fund. Further, state law requires that money derived from activities unique to each home must also be deposited into that home's morale fund, which is used to administer quality-of-life activities for the veteran residents, such as entertainment expenses, sports activities, and celebrations. Given this requirement, we believe that although the minimum rent that the golf course pays is deposited into the General Fund, the percentage rent payments from the golf course lease should be deposited into the morale fund, a viewpoint that CalVet agrees with. Therefore, between the convenience store and golf course leases, CalVet's failure to fully enforce the rental payments over the most recent three years means that the morale fund did not receive \$101,000 that could have been used for the veteran residents' benefit. Without an effective process for monitoring and enforcing compliance with lease payments, CalVet lacks assurance that lessees are making correct lease payments, and therefore it risks forgoing funds that it should collect for the benefit of the veterans.

DGS is likely better positioned to collect rent payments than CalVet is. Staff at neither DGS nor CalVet could explain why rent payment collection is split between the two departments or how the decision is made regarding which department should receive the payments for a lease. DGS manages the leases of state property, including collecting rental payments for several different state agencies. Its payment tracking system is more robust than CalVet's, making it better able to track rental payments. We found that DGS collected all of the lease payments it was responsible for and that it has mechanisms in place for enforcing compliance with lease payments. Consolidating the receipt of lease payments and monitoring by making DGS the sole department responsible for receiving all lease payments—except those dedicated to the morale fund—would likely enhance the efficacy of rent payment collection for veterans home properties.

As we state in the Introduction, the proceeds from lease payments are not a significant source of funding for the homes. Regardless, these funds should still supplement the funding that CalVet receives for the support and operation of the homes and therefore ultimately benefit the veteran residents. However, as shown in Figure 6, DGS and CalVet's overall failure to appropriately manage rental payments for leases of veterans home properties has prevented the homes from receiving a significant amount of funding.

Figure 6

The Veterans Homes Have Not Received a Significant Amount of Funding Because CalVet and DGS Failed to Properly Manage Rental Payments



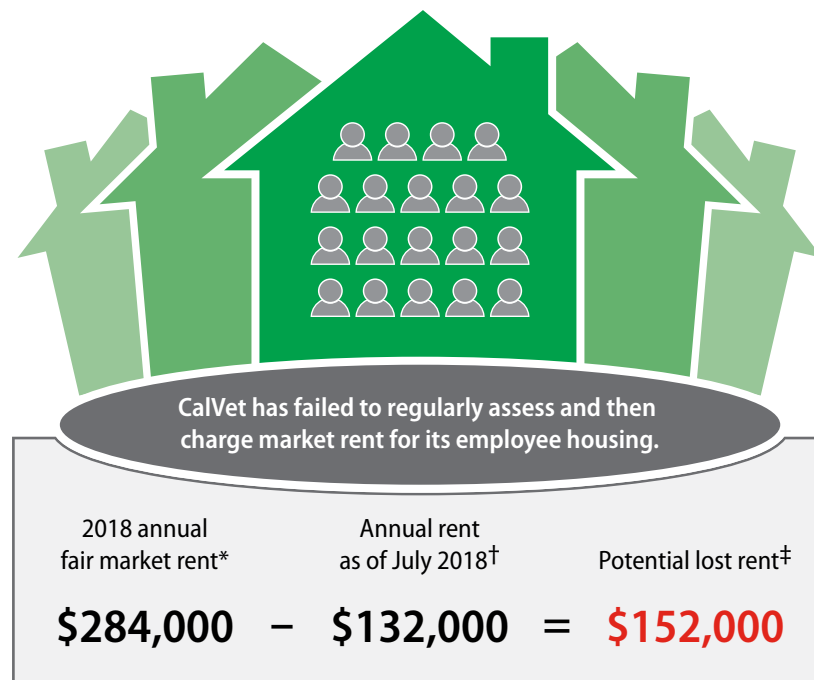
Source: Analysis of leases and rental payments that CalVet and DGS collected for payments due between July 2015 and June 2018.

CalVet's Poor Management of State-Owned Employee Housing Has Resulted in Forgone Revenue for the State

As discussed earlier, state law gives CalHR the responsibility for issuing rules that govern employee housing, and it is CalHR's policy that rental rates for all employee housing be set at fair market value. To this end, CalHR requires departments to conduct an appraisal of employee housing properties at least once every five years. The appraisals must be performed by an authorized certified appraiser. Further, a 2012 memo from CalHR's predecessor department suggests that departments meet this requirement by appraising 20 percent of their properties annually, which spreads out the costs of the appraisals. Reappraising some properties each year also allows departments to more quickly identify changes in the rental market so that they can take action to adjust rent amounts when market rates change. Lastly, CalHR requires departments to conduct an annual desk review of rental rates. CalHR representatives explained to us that departments can complete this desk review by analyzing rental rates of houses that are comparable with a department's employee housing units and then checking to see if the appraised value of employee housing is still consistent with current fair market value.

However, between 2013 and 2018, CalVet neither conducted the required desk review nor appraised a portion of its employee housing units each year and therefore did not ensure that the rents for these units kept pace with market value. CalVet obtained market value appraisals on all of Yountville’s employee housing properties in January 2013 and adjusted rental rates accordingly at that time. However, it did not then perform the required annual desk review or follow the guidance to reappraise 20 percent of the properties each year, and instead it had all of the housing units appraised again in June 2018, at the five-year point when CalHR policy required it to have completed all of the appraisals. Thus, CalVet complied with the five-year reappraisal requirement; however, because it did not comply with the requirement to conduct an annual desk review, it continued to use the 2013 appraisals as the basis for rent on employee housing. As shown in Figure 7, the June 2018 appraisal of the properties found that the 2013 rental rates CalVet had used to establish employee housing leases were far below the 2018 market rent.

Figure 7
CalVet’s Poor Oversight of Yountville’s Employee Housing Allowed Employees to Reside in Employee Housing Without Paying Market Rent



Source: Analysis of records pertaining to Yountville’s employee housing program.

* Fair market rent assumes full occupancy of habitable units.

† We used the rates from the 2013 appraisals of the habitable units to calculate this total because CalVet used those rates to set rental rates for housing during the period we reviewed.

‡ Potential lost rent assumes CalVet makes no change to employee rental rates.

According to CalVet's legal counsel, CalVet headquarters was not aware of CalHR's policy until sometime in the middle of 2018. The legal counsel also stated that ensuring compliance with CalHR policies was the Yountville housing committee's responsibility until the time that CalVet hired the state asset manager. However, as we stated previously, we believe CalVet should have maintained oversight of the employee housing leases to ensure that they complied with state law and policy. We expected that this oversight would also have included reviewing employee housing rental rates and ensuring that they are set at the fair market value.

Because CalVet did not ensure that its rents kept pace with the market, the State has gone without significant rental revenue. The discrepancy between the 2013 and 2018 market values suggests that over the course of the five-year period, staff were paying less than fair market value for their housing. The difference between the combined monthly rent at 2013 rates and the 2018 fair market value is about \$12,600 per month. As shown in Figure 7, this amounts to a potential loss of rental income in one year of \$152,000. Had CalVet completed the required desk review of its housing rate or more regularly appraised the employee housing at Yountville, it would have been better able to keep pace with market rates on its properties and therefore would have minimized forgone revenue.

Further, because CalVet did not regularly assess its properties, it has impaired its ability to raise rental rates to meet market value in the future for as long as the units remain occupied. Employee bargaining units generally prohibit state agencies from raising the rents on employee housing by more than 25 percent per year, unless the current tenant vacates the unit. To set its rents at the current market value, CalVet would have to increase them by an average of about 100 percent. Being limited to a 25 percent increase for its occupied units means that CalVet would collect \$119,000 less than the 2018 market value in the year following such an increase.

If CalVet had taken action to ensure that its rates were consistent with market value over the last five years, it would be better positioned to ensure that its current rates meet market value. For instance, if CalVet had appraised some employee housing units each year and identified that market rates had increased, it could have raised the rent on those units to better match the market. According to CalVet's assistant deputy, CalVet intends to wait until January 2019 to raise rents on employee housing, and it will raise them by 25 percent for all employees.

Finally, staff who live in the employee housing at the 2013 rental rates will now be faced with an additional source of taxable income. Internal Revenue Service (IRS) regulations establish that, subject to certain conditions, the fringe benefits an employee receives from

his or her employer, such as employee housing, are considered additional compensation and are therefore taxable. When an employee does not pay fair market value for a fringe benefit, the IRS considers the difference as additional compensation and a part of the employee's taxable gross income. For example, if an employee resides in housing valued at \$1,000 per month but pays only \$600 per month, the \$400 difference is taxable income. Employers are required to report that income to the IRS. Because CalVet did not obtain more frequent market value appraisals of employee housing properties, it has also not gradually increased rents and kept its employee residents informed of any additional taxable compensation they are receiving. Had CalVet performed more frequent assessments of its employee housing and adjusted housing rates accordingly, such additional taxable compensation likely would have been relatively small or even nonexistent. Instead, those employees are now responsible for a sizeable increase—in several cases thousands of dollars per year—in taxable income.

Recommendations

Legislature

To improve the effectiveness of lease payment collection, the Legislature should amend state law beginning in fiscal year 2019–20 to require that DGS receive lease payments for all veterans home property leases, except those for employee housing and those that are required to be deposited into the morale fund.

CalVet

To ensure that the veterans homes receive all of the funding to which they are entitled, by the May 2019 budget revision, CalVet should seek an augmentation to its appropriation for the homes equal to the lease revenues it generated from July 2015 through June 2018. If CalVet believes the state law requiring lease proceeds to augment its appropriation is outdated, it should seek a change to state law.

To monitor whether lessees are current on payments, CalVet should track payment compliance for all lease payments that it receives and promptly follow up with lessees that do not pay as required. This should include collecting sufficient records from lessees that pay rent based on a percentage of sales to calculate the amount that each is required to pay to ensure that the lessees are making the correct rent payments.

To better manage its employee housing, beginning in June 2019 CalVet should comply with CalHR requirements by annually reviewing the rental rates for its employee housing units to ensure their consistency with market value and adjusting the rental rates accordingly.

DGS

To ensure that it can justify the rental rates it approves, DGS should document its assessment of market value and market rent for all veterans home property leases before leasing the property. It should set rental rates equivalent to fair market rent in all cases except those in which it accepts improvements to the property or services to the veterans in exchange for reduced or waived rent. In the cases of reduced or waived rent, DGS should document a calculation of the value of the property improvements or services and reduce the rent by an amount equal to the calculated values.

To comply with state law, DGS should begin depositing lease payments from leases of veterans home property into the General Fund so that those funds may be used to augment the appropriation of the veterans homes, and it should reimburse the General Fund for the amounts it inappropriately deposited into the property acquisition law money account. DGS should also annually notify the Department of Finance and the Legislature of the amount of lease payments it collects to ensure that those proceeds are appropriately directed to the veterans homes.

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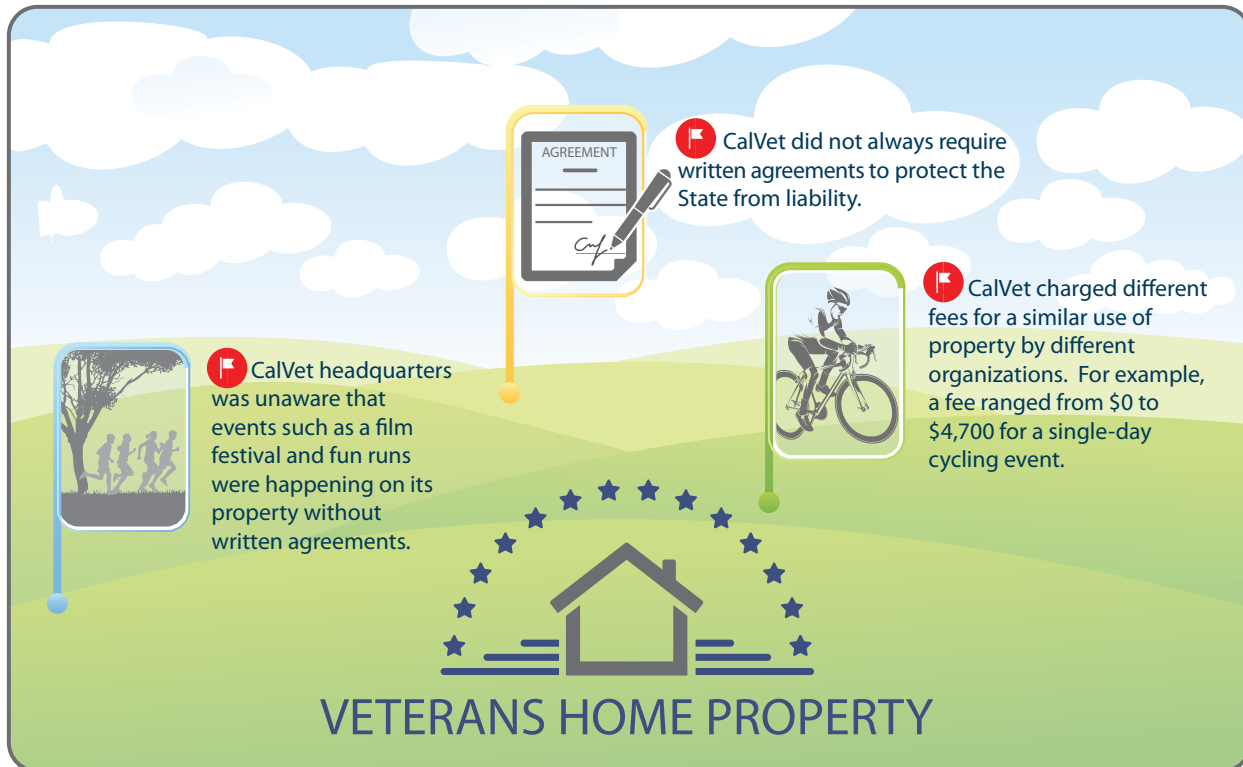
CalVet's Poor Oversight of the Veterans Home Properties Has Exposed the State to Risk and Caused CalVet to Forgo Revenue That Would Have Benefited Veterans

Key Points

- CalVet's lack of oversight allowed third parties to use veterans home properties on a short-term basis without written agreements that would protect the State from liability and without compensating the home. CalVet also approved one use of a home's property that appears to be contrary to the best interests of the veterans.
- CalVet has not adequately monitored compliance with the terms of the lease agreements. Its headquarters office did not know for several years that the golf course lessee was launching hot air balloons from Yountville, which is not allowed under the lease agreement. Although CalVet has now known about the balloon launching for two years, it still has not taken action to cease this risky activity.

CalVet Allowed Third Parties to Use the Veterans Home Properties Without Protecting the State From Liability or Collecting Fees That Could Benefit the Veterans

CalVet permitted third parties to use veterans home properties for short-term activities without properly protecting the State against risk. Figure 8 on the following page shows a summary of our findings related to these uses. State law generally does not require agencies to use written agreements when allowing third parties to use state property for events or other short-term activities. Regardless, we expected that if CalVet chose to allow third parties to use veterans home property for such purposes, it would require them to sign written agreements that protect the State's interests, including shielding the State from liability and requiring compensation for potential damage. However, according to legal counsel at CalVet, sometime after October 2016, CalVet headquarters became aware that Yountville had permitted third parties to use its property for various events without written agreements. CalVet's legal counsel stated that these uses occurred because of a lack of oversight from headquarters and a lack of good judgment by senior staff at Yountville, and he agreed that these uses of the property should have had written agreements to protect the State. Administrators of other veterans homes reported to us other short-term uses by third parties, also without agreements. If CalVet had maintained appropriate awareness of events taking place at its homes, it could have ensured that written agreements were in place to help protect the State from liability.

Figure 8**CalVet Failed to Properly Manage Third Parties' Use of Veterans Home Property for Events**

Source: Review of CalVet's records of short-term uses and correspondence with CalVet staff.

Some short-term uses of the property can carry inherent risks. For example, a woman was injured during a cycling event at Yountville and sued CalVet. In this particular case, the third party that sponsored the event had signed an agreement to use the home property that protected the State against claims for damages. The lawsuit was eventually dismissed because the woman did not properly file the complaint, but this incident demonstrates the risks involved in allowing these types of events on veterans home property and highlights the importance of using written agreements to reduce the State's exposure to liability.

CalVet has taken steps to formalize its process for permitting short-term uses, but it has been inconsistent in its implementation and its written agreements are inadequate. According to CalVet legal counsel, after headquarters became aware of the events occurring at Yountville, it developed a formal written agreement, which it calls a "license," for the short-term use of veterans home property. Appendix A on page 53 lists the licensed short-term uses that we identified that occurred at Yountville between October 2016

and July 2018. However, CalVet has required only some parties to obtain a license and has not required others to sign any agreement. Additionally, we reviewed 12 of CalVet's agreements for the short-term use of the Yountville property and found that although the agreements appropriately indemnified the State against liability and required the third parties to obtain insurance, not all of the agreements adequately required the third party to be responsible for damage to the property. Two of the agreements stated that the third party would accept responsibility for damage or theft sustained by the town of Yountville but did not require the same for any damage that occurred to the veterans home property. According to CalVet's legal counsel, the inconsistency in the use of the agreements has occurred because CalVet has not developed a policy or procedure for permitting short-term uses of the property and because staff at Yountville did not alert headquarters that the short-term uses were occurring. Without consistently requiring written agreements and without including adequate terms in those agreements, CalVet is not adequately protecting the State's interests when allowing third parties to use the property.

Further, CalVet charged inconsistent fees and missed an opportunity to obtain additional revenue for veteran residents by permitting some short-term uses without collecting a fee. State law requires CalVet to deposit funds from activities unique to a veterans home into the morale fund for that home, which the home can then use for activities that support the general welfare of its residents. According to its legal counsel, CalVet has interpreted the short-term uses of the veterans home properties to be activities unique to the homes and it deposits the funds that it collects from these activities into the morale funds. However, CalVet acknowledged that it has not always charged third parties to use the properties and therefore did not collect all of the funds it could have. Additionally, the fees that CalVet has charged have at times been inconsistent. For example, in August 2017 CalVet licensed space at Yountville for a cycling event with an estimated attendance of 2,000 people and charged the nonprofit organization hosting the event \$4,460. However, CalVet did not charge another organization a fee for a cycling event on the property in April 2018 with more than 2,000 participants and instead accepted a donation of tickets to enter the event. This inconsistency risks creating the perception that CalVet is unfair in its administration of licensed uses of its property. According to CalVet's legal counsel, the fees are inconsistent because CalVet has not developed a set fee schedule.

Finally, one use of a veterans home property appeared to be contrary to the best interests of the veterans. Because the primary purpose of the properties is to provide for the care and welfare of the veteran residents, we expected that CalVet would ensure that all short-term uses of a property by third parties were

consistent with the best interests of the veterans. However—similar to our earlier discussion on leases of veterans home property—until December 2018 CalVet had not developed criteria for making decisions regarding such uses. In September 2018, the West Los Angeles veterans home allowed a film production company to use the home to film a television show. According to CalVet’s website, most of that property is a skilled nursing facility, where veterans receive 24-hour access to nursing services.

One use of a veterans home property—to film a television show—appeared to be contrary to the best interests of the veterans.

Therefore, the presence of a film crew could be disruptive to the veteran residents. Additionally, the agreement for the use of the home by the production company restricted both CalVet’s and the veteran residents’ remedies for any violation of the residents’ privacy. A recent settlement between the U.S. Department of Health and Human Services and three hospitals that permitted similar activity demonstrates the risk to which CalVet potentially exposed the veteran residents and the State. Specifically, the U.S. Department of Health and Human Services agreed to a \$1 million settlement with the three hospitals after those hospitals allowed a television show to film on their premises without patient authorization, therefore compromising the privacy of the patients’ protected health information.

It appears that the decision to allow filming within the West Los Angeles veterans home was made in part because of outside influence. In August 2018, one month before the filming occurred, the deputy director of the California Film Commission sent a letter to the secretary of CalVet stating that CalVet’s assistant deputy had firmly denied the request to film at the veterans home and asking that the secretary allow the filming. Shortly thereafter, the deputy administrator of the West Los Angeles veterans home, with CalVet headquarters’ approval, signed the agreement allowing the filming to occur. CalVet should not allow third parties to have undue influence on the uses of the veterans home property, and it should prioritize the best interests of the veteran residents above other interests. Other uses of veterans home property have occurred, such as cycling events, fun runs, and annual baseball tournaments, all of which may provide entertainment to veteran residents or may be disruptive. Available estimates show that these events can bring hundreds of people to the property. As is the case

with CalVet's long-term leases of veterans home property, which we discussed earlier, CalVet had not developed criteria for making decisions regarding these short-term uses.

CalVet has only recently taken steps to address unsanctioned and undocumented short-term use of its veterans home properties, and as discussed earlier, our review identified deficiencies in its attempts to better manage those uses, including inconsistency in requiring written agreements and the fees it charges. In December 2018, CalVet issued a policy governing uses of veterans home property, which was effective immediately. The policy addresses some of our concerns, including establishing criteria for what short-term uses of the property are in the best interests of the homes and requiring a written agreement for all third-party use of the property, but it does not address other concerns. The policy does not establish a fee schedule or require that written agreements for short-term uses include terms to protect the State's interests, such as requiring a third party to pay for damages that it causes to the property. Because of these deficiencies, and because of CalVet's past failures to ensure that uses of veterans home properties were consistent with the best interests of the home, we believe that CalVet should be required to incorporate into regulation criteria for determining what short-term uses are in the best interests of the homes and their residents. These criteria should also encompass protections against liability and consistency in the fees that CalVet charges for short-term uses.

CalVet Exposed the State and Yountville to Risk by Failing to Monitor Compliance With Lease Terms

CalVet does not adequately monitor tenants' compliance with lease terms. Although DGS is responsible for managing leases of state property, its leasing manager explained that DGS relies on the agency with jurisdiction over the property to monitor compliance with lease terms, which, in the case of the veterans homes, is CalVet. Because CalVet has a regular presence at the homes and is therefore better able to monitor day-to-day compliance with the leases, we believe DGS's delegation is reasonable. Accordingly, we would expect CalVet to monitor lessees' compliance with the terms of their leases, such as the terms that require a lessee to maintain the property and that prohibit a lessee from subletting the property without the State's consent. However, CalVet has not adequately done so. Although CalVet's assistant deputy agrees that CalVet should monitor for compliance, he believes that the line of responsibility between CalVet and DGS was not always clear. He also stated that CalVet delegates authority to Yountville for enforcing compliance with lease terms. However, he acknowledged that CalVet did not make sure that Yountville was monitoring or enforcing lease compliance.

In September 2017, CalVet hired a state asset manager and tasked that individual with monitoring lessee compliance with lease terms. Despite CalVet's expectations, that state asset manager indicated that he did not develop any policies or procedures for monitoring compliance with the leases and did not conduct regular monitoring. Further, according to the assistant deputy, CalVet did not begin reviewing whether that state asset manager was enforcing compliance with leases until at least March 2018, seven months after he was hired. As we discussed earlier, CalVet terminated his employment shortly thereafter, in August 2018. Because CalVet has not adequately monitored compliance with lease terms, it has less assurance that lessees are complying with the terms of their leases, which increases the risk that lessees will engage in activities that expose the State to financial or legal risks. Additionally, failure to enforce the terms of the leases could be detrimental to the residents of the homes if lessees engage in or allow activities that are disruptive to the residents.

We became aware of one instance that demonstrates the importance of monitoring lessees to verify that they use State property appropriately. The lease for the Yountville golf course property restricts the permissible uses of the property to those reasonably related to recreational golf. However, in November 2009 the golf course lessee sent a written request to Yountville management for permission to launch hot air balloons from the golf course. The deputy administrator responded that the home did not anticipate any impact on the residents' quality of life nor on the liability for the State resulting from balloon launches and therefore did not object to the activity. However, because launching hot air balloons is not a permissible activity under the lease terms, permitting the activity would require a modification to the lease. As the entity with responsibility for leasing state property, DGS would have to approve such a modification. However, according to the chief of DGS's asset management branch, DGS did not approve any such modification and was not aware of the balloon launches until July 2017.

The golf course lessee's current agreement with the hot air balloon company allows it to launch up to 10 hot air balloons every day in exchange for almost \$3,000 per month, and the company charges passengers a fee. Despite the frequency of the launches, email records indicate that CalVet headquarters became aware of the balloon launches in July 2016. We find CalVet headquarters' lack of awareness puzzling, given the size and spectacle of the balloon launches, as depicted in Figure 9. Additionally, hot air balloon riding is an inherently risky activity where crashes can result in serious injury or death. The hot air balloon launches therefore create the risk of liability for the State, and we expected CalVet to have taken immediate action to stop the launches when it learned of them. However, CalVet's assistant deputy stated that CalVet had not taken action to cease the balloon launches because doing so was not

a priority. In addition, the assistant deputy said that CalVet believed it might have ratified the agreement between the home and the golf course lessee by allowing the activity to continue. CalVet's lack of oversight over its leased property and its failure to take swift action to enforce the terms of the golf course lease have exposed the State to increased risk of liability.

Figure 9

CalVet Headquarters Was Not Aware Until 2016 That Hot Air Balloons Were Launched From the Golf Course Despite the Spectacle the Balloon Launches Create



Source: Auditor observation during a visit to the Yountville veterans home and email records from CalVet.

Recommendations

Legislature

To protect the interests of the State and veterans homes, the Legislature should amend state law to do the following:

- Require CalVet to promulgate regulations that define what types of short-term uses of veterans home property are in the best interests of the homes, including the interests of the residents of the homes, and to include in all short-term use agreements conditions that protect the State's best interests.
- Prohibit CalVet from approving any short-term uses of the veterans home property that do not meet its definition of the best interests of the home.
- Require CalVet to develop and implement a fee schedule for short-term third-party uses of veterans home property.

CalVet

To prevent unauthorized use of its property, CalVet should regularly monitor the use of the leased properties and take action to cease any activity that is not allowed by the terms of the lease agreements. Further, it should take action to cease the balloon launches from the golf course or amend its lease with the lessee to identify balloon launches as an approved use of the property.

OTHER AREA WE REVIEWED

To fully address the audit objectives that the Joint Legislative Audit Committee (Audit Committee) approved, we also reviewed the subject area described below. The discussion that follows indicates the results of our review and the associated recommendation that we do not cover in other sections of this report.

CalVet Failed to Report Lease Revenue to the Legislature

State law requires that CalVet submit two annual reports to the Legislature containing, among other items, an accounting of any money that CalVet has budgeted as revenue or recoveries to the General Fund. Because state law requires that the revenue from leases of veterans home properties be deposited in the General Fund, we expected that the reports CalVet submits to the Legislature would include the lease revenue. However, CalVet's chief budget officer confirmed that CalVet did not include revenue from leases in the reports it submitted to the Legislature during our review period of fiscal years 2015–16 through 2017–18. She explained that CalVet had not reported the lease revenue because the template for the reports to the Legislature did not include direction to include it. However, she agreed that the reports should include the lease revenue. As discussed earlier, we recommend that DGS receive all lease payments except for those required by law to be deposited in the morale fund.

Recommendation

To inform the Legislature about all sources of General Fund revenue, beginning with its May 2019 report CalVet should include lease payments in its required report until such a time as the Legislature centralizes receipt of these lease payments at DGS.

We conducted this audit under the authority vested in the California State Auditor by section 8543 et seq. of the California Government Code and according to 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 specified in the Scope and Methodology section of the report. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Respectfully submitted,



ELAINE M. HOWLE, CPA
California State Auditor

Date: January 29, 2019

APPENDIX A

Short-Term Uses of Veterans Home Properties

Table A shows the short-term uses of the Yountville veterans home that we were able to identify for October 2016 through July 2018. However, this table cannot be considered an exhaustive list. As described in the body of our report, CalVet did not consistently license short-term uses of its properties. This list is compiled from CalVet records of uses of its property.

Table A

Third-Party Uses of the Yountville Veterans Home Property From October 2016 Through July 2018

LICENSEE	USE	DATE(S) OF USE	FEE
Cinema Napa Valley	Film festival	November 7-14, 2016	\$2,000
Friends of the Lincoln Theater	Volvo informational event	February 13-24, 2017	2,000
Yountville Live	Parking for festival	March 15-19, 2017	2,000
Community Building Partners	Volunteer renovation project	May 10-24, 2017	Fee waived in exchange for renovation work at Yountville
Suscol Intertribal Council	Pow wow	July 8-9, 2017	1,600
American Legion	Baseball tournament	July 23-August 7, 2017	Fee waived in recognition of past contributions by the Legion to Yountville
Veterans of Foreign Wars District 16	Picnic for home residents	August 13, 2017	—
Eagle Cycling Club	Bicycle ride	August 19-20, 2017	4,460
ALS Association	Bicycle ride and walk	September 22-23, 2017	2,100
ZD Wines	Bicycle ride and festival	October 14, 2017	400
Yountville Live	Parking for festival	March 14-18, 2018	10,000
Community Building Partners	Volunteer renovation project	April 1-May 7, 2018	Fee waived in exchange for renovation work at Yountville
Ride Napa Valley	Bicycle ride	April 20-21, 2018	Fee waived in exchange for 20 rider packets and 20 tickets
Healing Walk Napa Valley	Walk	April 28-29, 2018	190
National MPS Society	5k run and picnic	April 29, 2018	1,800
American Diabetes Association	Bicycle ride	May 3-6, 2018	9,492
ZD Wines	Bicycle ride and festival	May 12, 2018	400
Napa Valley Education Foundation	Run and walk	May 19, 2018	2,400
Napa County Election Division	Polling location	June 1-6, 2018	Fee waived in exchange for allowing residents to use polling booths
Native Sons and Daughters of the Golden West Chapter	Community picnic	July 15-16, 2018	Fee waived in exchange for free meals for Yountville residents
American Legion	Baseball tournament	July 21-August 6, 2018	2,000

Source: Analysis of third-party use agreements collected from CalVet headquarters and Yountville and supporting documents.

Note: This table contains all short-term uses we were able to identify that had a written agreement.

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APPENDIX B

Scope and Methodology

The Audit Committee directed the California State Auditor to examine CalVet's leases and other third-party uses of state property at the veterans homes. Specifically, we were directed to review how CalVet and DGS establish leases of veterans home property and comply with state law. Table B lists the objectives that the Audit Committee approved and the methods we used to address them.

Table B
Audit Objectives and the Methods Used to Address Them

AUDIT OBJECTIVE	METHOD
1 Review and evaluate the laws, rules, and regulations significant to the audit objectives.	Reviewed and evaluated relevant laws, rules, and regulations.
2 Determine the number of active leases of state-owned property at the veterans homes and identify the value of those leases.	Interviewed CalVet and DGS staff and reviewed supporting documentation, including lease and short-term use agreements as well as maps and floor plans, to determine the number of leases and other agreements for the use of the veterans home property that existed at each veterans home and the value of those leases and agreements.
3 Evaluate the processes used to establish leases of state property within the veterans home system by performing the following: a. Identify the current processes used by CalVet and DGS to pursue, renew, recommend, and approve leases of properties and determine whether these processes comply with legal requirements. b. Determine the local administrator's role at each veterans home in negotiating, recommending, monitoring, and approving leases and other third-party uses.	<ul style="list-style-type: none"> • Interviewed CalVet staff regarding current processes for leasing veterans home property. Reviewed CalVet's new leasing policy that it published during our audit in December 2018. • Interviewed CalVet staff and reviewed CalVet's employee housing policy and documentation regarding its review and approval of employee housing leases. • Interviewed DGS staff and reviewed DGS's policies and procedures to document the current processes it uses to lease veterans home properties and compared the policies and procedures to requirements in state law and regulation. <ul style="list-style-type: none"> • Interviewed CalVet staff to determine the role that home administrators had in establishing and managing leases of home property before May 2018. • Reviewed CalVet's May 2018 memorandum to its veterans home administrators. • Interviewed staff at CalVet and the eight veterans homes to confirm their understanding of the administrator's current role in approving uses of the veterans home properties.

continued on next page ...

AUDIT OBJECTIVE	METHOD
<p>4 Review active leases of state property within the veterans home system to determine the following:</p>	
<p>a. How active leases were pursued, renewed, recommended, and approved. Evaluate the processes used by CalVet and DGS to establish and approve the terms of the lease agreement.</p>	<ul style="list-style-type: none"> • Reviewed 11 active leases and supporting documentation to determine and evaluate the process that CalVet and DGS used to review and approve leases of veterans home properties, including whether the leases complied with state law and best practices. • Reviewed 10 employee housing leases and supporting documentation to evaluate the terms contained in the leases as well as CalVet’s process for approving employee applications for housing.
<p>b. Whether CalVet or DGS have determined that the rates charged on the leases of state property compare reasonably to similar market rates. Identify assumptions used in the market comparison.</p>	<ul style="list-style-type: none"> • For the leases selected under Objective 4(a), reviewed supporting documentation and interviewed staff at CalVet and DGS to identify the methods used to establish the rental rates, including the frequency of assessing the value of leased property. • Contracted with two real estate appraisers to assess the market value of the theater, museum, and golf course at Yountville and compared the results of those assessments to the current rent charged for those properties.
<p>c. How often CalVet or DGS assesses the value of the leased properties.</p>	<ul style="list-style-type: none"> • For employee housing leases, reviewed market value appraisals that CalVet had obtained in January 2013 and June 2018 for employee housing units and compared those assessed values to the rates that CalVet had established for those units.
<p>d. Whether there are variations in lease terms—including the rates of increase, duration, and renewals—and the reasoning for such variation.</p>	<ul style="list-style-type: none"> • Documented the terms of the active leases of veterans home properties, including the duration, rent, rate of rent increase, and renewal options as shown in Table 1 on page 6. Interviewed CalVet and DGS staff to determine reasons for variation in lease terms. CalVet and DGS were unable to explain the reasoning for the variation in the lease terms due to the length of time that has passed since many were established. • Reviewed terms contained in the leases for 10 employee housing units reviewed under Objective 4(a), including the presence of key terms, rental rates, and whether the employee had received priority housing.
<p>e. Whether the lease terms and conditions include in-lieu payments. If so, determine how the in-lieu payments were determined.</p>	<p>Reviewed leases in which DGS reduced rental payments in exchange for services or improvements and interviewed staff at DGS to determine the methods that DGS used to establish the amount of the rent reduction.</p>
<p>5 Review active leases to determine how the leased properties are being used.</p>	
<p>a. Identify whether unsanctioned uses of leased property are occurring.</p>	<ul style="list-style-type: none"> • Interviewed staff at CalVet, reviewed records of events that occurred at Yountville, and conducted Internet research to identify uses of leased property at Yountville.
<p>b. Determine whether certain uses of leased property, such as paid event parking and special outdoor events, are approved by the property manager and incorporated in the lease terms.</p>	<ul style="list-style-type: none"> • Reviewed the terms of the associated leases to determine whether the terms of the leases authorized the uses. • Determined that uses of leased property were generally consistent with the terms of the leases, with the exception of hot air balloon launches from the golf course property. We reviewed uses for special events that extended beyond leased property under Objective 7.

AUDIT OBJECTIVE	METHOD
<p>6 Evaluate CalVet's and DGS's oversight of active lease agreements.</p>	
<p>a. Determine the extent to which CalVet and DGS ensure that lessees are complying with the terms and conditions of leases.</p>	<p>Interviewed staff at CalVet, DGS, and Yountville to identify policies and procedures associated with monitoring compliance with lease terms.</p>
<p>b. Evaluate how CalVet tracks and reports lease payments to determine if it is complying with relevant state laws and regulations.</p>	<ul style="list-style-type: none"> • Interviewed staff at CalVet and DGS and reviewed lease payment tracking documentation to determine how the departments track lease payments. • Reviewed 15 leases and the payments that CalVet and DGS collected from the lessees during fiscal years 2015–16 through 2017–18 to determine whether CalVet and DGS records indicated that the lessees had made all required payments. • Reviewed documentation and interviewed staff at CalVet and DGS to determine whether CalVet and DGS had taken action to enforce payment compliance for any leases. • Reviewed CalVet's reports to the Legislature on its revenues deposited to the General Fund for fiscal years 2015–16 through 2017–18 to determine whether the reports complied with state law by including lease payment revenue.
<p>c. Evaluate the method by which the proceeds from the lease agreements have been reinvested into the veterans homes in accordance with state law, and determine whether this requirement has ever informed decisions about lease terms.</p>	<ul style="list-style-type: none"> • Interviewed CalVet and DGS staff and reviewed documentation to determine where CalVet and DGS deposit lease payment revenues, including whether the payments were made to the General Fund or the morale fund in accordance with state law. • Reviewed leases and supporting documentation and interviewed staff at CalVet and DGS to determine the methodologies used to set rental rates for the 10 leases selected for review under Objective 4(a) that DGS approved.
<p>7 Determine the extent to which third parties use veterans home property without having lease agreements in place. Identify the terms of these arrangements and the authority under which the parties in these arrangements operate.</p>	<ul style="list-style-type: none"> • Interviewed staff at CalVet and the veterans homes, reviewed documentation, and conducted Internet research to identify uses of veterans home property. • Reviewed documentation and interviewed staff at CalVet regarding the four entities using property without a lease. • Interviewed staff at CalVet headquarters and Yountville to identify and evaluate policies and procedures for approving short-term uses of the veterans home property by third parties. • Reviewed and evaluated a selection of 12 agreements for the short-term use of the veterans home, along with supporting documentation, including whether those agreements contained key terms to protect the State's interests, the fees CalVet charged, and whether the agreements appeared to be in the best interests of the home.
<p>8 Review and assess any other issues that are significant to the audit.</p>	<p>We reviewed no additional areas.</p>

Source: Analysis of the Audit Committee's audit request number 2018-112 and information and documentation identified in the table column titled *Method*.

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STATE OF CALIFORNIA

GAVIN NEWSOM, Governor

DEPARTMENT OF VETERANS AFFAIRS

1227 O Street
Sacramento, California 95814
Telephone: (800) 952-5626
Fax: (916) 653-2456



January 14, 2019

Elaine M. Howle, CPA*
California State Auditor
621 Capitol Mall, Suite 1200
Sacramento, CA 95814

Dear Ms. Howle:

Thank you for the opportunity to review and comment on California State Auditor (CSA) Report 2018-112, related to leases and other state property use in the Veterans Homes of California – and in particular, the Yountville Veterans Home. I welcome the findings of this audit and I appreciate the diligence and professionalism of your staff.

At the start of my tenure as Secretary of the California Department of Veterans Affairs (CalVet), I immediately recognized a significant lack of oversight and standardization in CalVet's Homes Division operations. The Veterans Homes were largely independent from each other and from headquarters, resulting in poor clinical survey performance, weak administrative controls, and varied policies and procedures. The most critical operations were triaged and I redirected resources accordingly. For much of the past three years, I reorganized Homes Division's structure to focus on the adoption and standardization of best practices in a variety of areas, including clinical procedures; admissions; the Morale, Welfare, and Recreation Fund; contracting, personnel, and other administrative operations; emergency preparedness; regulation development; maintenance and construction oversight; and many other key functions. This standardization of core functions improved service delivery and has facilitated a coordinated, statewide approach to planning and decision making. With patient care performance ratings increased and structural issues dramatically enhanced, CalVet can now turn its attention to other operations, like lease management, that require similar improvements but are not – and should not become – part of the Veterans Homes' primary mission.

As reflected so clearly in your report, the Veterans Home of California – Yountville engaged in unfavorable property use arrangements for decades. While CalVet may be tethered to several old leases for years to come, we have restructured or terminated other arrangements and continue to work on further improvements. Since 2015, CalVet has made significant progress improving property management. CalVet has renegotiated prior agreements to ensure leases better serve residents and protect state interests; developed a licensing program for short-term uses of the campus; redirected staff to oversee property use; and begun assessing the best future uses of each Veterans Home. The audit recommendations, all of which have been implemented or will be implemented in the coming months, are critical to continuing to enhance property management. In anticipation of the audit and while it was conducted, many changes were implemented to create clear policies and procedures for program oversight and to centralize decision-making authority among appropriate leadership in Sacramento.

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* California State Auditor's comments appear on page 65.

CalVet is absolutely committed to ensuring that all property use is in the best interest of the Veterans Homes and their residents, while complying with all applicable rules and regulations. I recently approved specific, strict approval criteria to ensure that all new or renewed property use agreements provide a significant benefit for the Veterans Homes and their residents. CalVet will no longer permit arrangements that do not further our mission. Regrettably, many non-compliant agreements were approved several decades ago. For instance, the leases that improperly exceed the State's maximum duration of five years were entered into between 1988 and 2012, and include terms that provide little or no opportunity for renegotiation. Several of these leases provide limited benefits to residents, require little or no rent, and restrict CalVet's ability to utilize the Veterans Home campus to its full potential. CalVet will partner with the Department of General Services (DGS) to revisit each of these leases and explore opportunities to maximize the benefits to the Veterans Home.

CalVet has made significant improvements over the last three years, but there is more to do. Your report is a tremendous asset to me and my executive team as we continue to correct many of the inappropriate arrangements and inadequate practices stemming from decades of poor stewardship of CalVet property. This audit will generate germane and meaningful policy discussions about the evolution of veterans' long-term care and the best uses of the Veterans Homes' system – discussions which are long overdue. With greater accountability, coordination, and planning, CalVet will better serve our residents and ensure that any uses of the Veterans Homes will truly be in concert with the needs of California's veterans.

The following are CalVet's specific responses to each recommendation provided within the report:

Audit Recommendation #1:

To ensure that future leases of veterans home property are established in accordance with state requirements, CalVet should implement its property use policy when considering all proposed leases of veterans home property.

CalVet's Response #1:

CalVet agrees with and has begun implementing this recommendation. In May 2018, I directed that all authority for approving property use be revoked from the Veterans Homes and centralized within CalVet's executive leadership in headquarters. Further, I directed the development of a new property use policy, which I approved in December 2018, to better comply with state law and to ensure effective management of Veterans Home property. This policy went into effect and is already helping manage and guide decision making throughout the Homes Division. I have further directed that the new property use policy be subject to formal regulatory development to ensure transparency, due process, and continuity across leadership eras. The new policy includes protocols and procedures for developing and approving lease agreements, as well as specific criteria outlining uses of property that are in the best interests of the Veterans Homes and their residents. These criteria draw heavily from landmark federal legislation concerning the appropriate uses of the Greater Los Angeles campus of the United States Department of Veterans Affairs. CalVet executive leadership will continue to monitor property usage and ensure the policy continues to be followed.

Audit Recommendation #2:

To ensure that it protects the State and the best interests of the Yountville veterans home, by March 2019 CalVet should complete its review of the four entities that do not have leases and should begin either evicting the entities or obtaining lease agreements with them through DGS.

CalVet's Response #2:

CalVet agrees with and has begun implementing this recommendation. As detailed in the audit report, one lease is currently being negotiated with support from DGS. We are currently reviewing the three other arrangements and will notify each entity of our determination, taking appropriate action as necessary in the best interests of the Veterans Home. CalVet will report these decisions to the CSA by March 2019.

Audit Recommendation #3:

To ensure that its employee housing lease agreements are sufficient to protect the State, by June 2019 CalVet should revise its existing employee housing leases in accordance with the guidance CalHR has provided to agencies to protect the State's interests, including making sure that they include terms that fully indemnify the State against damages and require rental insurance.

CalVet's Response #3:

CalVet agrees with and has begun implementing this recommendation. CalVet legal counsel developed new employee housing leases and all staff in employee housing have signed the new leases, which we will provide to the CSA for evaluation. These leases protect state interests, follow CalHR recommendations, and clarify tenant responsibilities. Approval authority for employee housing leases now rests with a select few executive staff with my direct engagement and oversight.

Audit Recommendation #4:

To avoid the appearance of impropriety and ensure property management of employee housing, CalVet should implement its new housing policy and ensure that employee housing decisions are made by its headquarters office in a clear and consistent manner.

CalVet's Response #4:

CalVet agrees with and has begun implementing this recommendation. The new housing policy provides explicit direction on various aspects of the state-owned housing program, including payment of rent, eligibility, and tenant rights and responsibilities. Additionally, housing is now apportioned to maximize the benefit to the Veterans Home, prioritizing employees with critical roles during emergency operations or positions that are difficult to recruit. All housing decisions are now made by headquarters to ensure comprehensive, effective, and equitable oversight and to eliminate any real or potential conflicts of interest. CalVet will also promulgate regulations to ensure the housing program continues to be managed appropriately.

Audit Recommendation #5:

To ensure that the veterans homes receive all of the funding to which they are entitled, by the May 2019 budget revision, CalVet should seek an augmentation equal to the lease revenues it generated from July 2015 through June 2018. If CalVet believes the state law requiring lease proceeds to augment its appropriation is outdated, it should seek a change to state law.

CalVet's Response #5:

CalVet reviewed the existing statutory language in Military and Veterans Code section 1023(b) and determined that it is reflective of outmoded budgeting practices and has been obsolete for more than a decade. This section and several others should have been updated as part of the fiscal year 2008-09 budget and are not reflective of CalVet's current operations. Therefore, CalVet will seek technical revisions to eliminate these references, and to bring them in compliance with the existing budget structure.

Audit Recommendation #6:

To monitor whether lessees are current on payments, CalVet should track payment compliance for all lease payments that it receives and promptly follow up with lessees that do not pay as required. This should include collecting sufficient records from lessees that pay rent based on a percentage of sales to calculate the amount that each is required to pay to ensure the lessees make the correct rent payments.

CalVet's Response #6:

CalVet agrees with and has begun implementing this recommendation. CalVet is currently reviewing all payment records and will take appropriate action against lessees that have not paid as required or have not adhered to any other lease terms and conditions. Based on our review of the full, unredacted audit report, CalVet will coordinate with DGS to develop new processes to monitor lease payments based on best practices.

Audit Recommendation #7:

To better manage its employee housing, beginning in June 2019 CalVet should comply with CalHR requirements by annually reviewing the rental rates for its employee housing units to ensure their consistency with market value and adjusting the rental rates accordingly.

CalVet's Response #7:

CalVet agrees with and has begun implementing this recommendation. The new employee housing policy reflects this annual review requirement. CalVet headquarters will continue maintaining oversight of employee housing and will conduct annual reviews as required. All leases will be reviewed by CalVet legal counsel and approved by select members of the CalVet leadership team. CalVet will adjust rental rates, as appropriate, in accordance with CalHR policy and guidance.

Audit Recommendation #8:

To prevent unauthorized use of its property, CalVet should regularly monitor the use of the leased properties and take action to cease any activity that is not allowed by the terms of the lease agreements. Further it should take action to cease balloon launches from the golf course or amend its lease with the lessee to identify balloon launches as an approved use of the property.

CalVet's Response #8:

CalVet agrees with and has begun implementing this recommendation. CalVet has reviewed every lease agreement and will be taking enforcement action where appropriate. CalVet will ensure all lessees comply with the terms of their leases. I have directed that no balloon launches or any other high-risk activities be conducted or approved on Veterans Home property and my executive leadership team will work with DGS to take any necessary steps to cease balloon launches from the golf course.

Audit Recommendation #9

To inform the Legislature about all sources of General Fund revenue, beginning with its May 2019 report CalVet should include lease payments in its required report until such a time as the Legislature centralizes receipt of these lease payments at DGS.

CalVet's Response #9:

CalVet agrees with and has implemented this recommendation. This oversight has been corrected and lease payment information was reflected in the January 10, 2019 budget estimate package for the Governor's 2019-20 budget. (2)

Again, thank you for sharing your findings. These recommendations will be a tremendous asset to CalVet as we continue to improve leasing protocols and ensure every use of the Veterans Homes is in the best interests of our veterans.

Sincerely,



Vito Imbasciani MD
Secretary

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COMMENTS

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM THE CALIFORNIA DEPARTMENT OF VETERANS AFFAIRS

To provide clarity and perspective, we are commenting on CalVet's response to the audit. The numbers below correspond to the numbers we have placed in the margin of its response.

Our report focuses on leases of veterans home property that were active as of June 2018. Accordingly, we cannot comment on whether these leases better serve residents and protect state interests in a manner that is improved over that of prior agreements. Similarly, the scope of our review did not include an evaluation of the manner in which CalVet has assigned staff to manage home property, so we cannot comment on its redirection of staff to oversee property use. Finally, CalVet references the licensing program it developed for short-term uses of the homes. We identified deficiencies in this program, which we discuss beginning on page 43.

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CalVet refers to actions it took after we shared our draft report for its review and comment. We look forward to reviewing documentation of CalVet's progress in implementing our recommendation in its 60-day, six-month, and one-year responses to our audit.

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January 2019



CALIFORNIA GOVERNMENT OPERATIONS AGENCY

GAVIN NEWSOM

California Governor

MARYBEL BATJER

Secretary

January 14, 2019

Elaine M. Howle, State Auditor*
 California State Auditor
 621 Capitol Mall, Suite 1200
 Sacramento, CA 95814

DEPARTMENTS

Office of
 Administrative Law
 Franchise Tax Board
 Department of
 General Services
 Department of
 Human Resources
 State Personnel Board
 Public Employees'
 Retirement System
 State Teachers'
 Retirement System
 Department of
 Technology
 Victim Compensation
 Board
 Department of Tax and
 Fee Administration
 California Complete
 Count Office

Re: CALIFORNIA STATE AUDITOR'S REPORT NO. 2018-112

Pursuant to the above audit report, enclosed are the Department of General Services' comments pertaining to the results of the audit.

The Government Operations Agency would like to thank the state auditor for its comprehensive review. The results provide us with the opportunity to better serve our clients and protect the public.

Sincerely,


 Marybel Batjer, Secretary
 Government Operations Agency

Enc

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 Suite 200
 Sacramento, CA 95814

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www.GovOps.ca.gov

* California State Auditor's comments begin on page 73.

January 2019



MEMORANDUM

Date: January 14, 2019

To: Marybel Batjer, Secretary
Government Operations Agency
915 Capitol Mall, Suite 200
Sacramento, CA 95814

From: Daniel C. Kim, Director
Department of General Services

Subject: **RESPONSE TO CALIFORNIA STATE AUDITOR'S REPORT NO. 2018-112**

Thank you for the opportunity to respond to the California State Auditor's (state auditor) Report No. 2018-112, [Redacted] Department of General Services: *The Department's Mismanagement of the Veterans Home Properties Has Not Served the Veterans' Best Interests and Has Been Detrimental to the State*, which addresses recommendations to the Department of General Services (DGS) resulting from its audit. The following response addresses each of the recommendations.

OVERVIEW OF THE REPORT

DGS has reviewed the findings, conclusions and recommendations presented in Report No. 2018-112, and generally agrees with the state auditor's recommendations.

In summary, the state auditor reviewed existing leases entered into by DGS on behalf of the Department of Veterans Affairs (CalVet), several of which are long-term leases dating back as far as 1988. The auditor identified a number of opportunities for improvement in the administration of these leases and made 5 recommendations, which are as follows:

- (1) Develop a definition for what constitutes "the best interest of the veterans homes" for leases let under Military and Veterans Code Section 1023,
- (2) Collaborate with CalVet to review existing leases that may be voidable or not in the best interests of the state, and remedy those leases as appropriate,
- (3) Issue a formal reminder to departments about DGS' role and leasing authority to prevent voidable leases being entered into by departments without DGS oversight,
- (4) Better document the rationale for rental rates, including benefits in-lieu of rent,

Marybel Batjer

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January 14, 2019

- (5) Deposit payments from leases of veterans homes into the General Fund, reimburse funds mistakenly deposited into the Property Acquisition Law Money Account, and report on payments collected so that the Department of Finance (DOF) and the Legislature can provide a corresponding augmentation to CalVet.

DGS believes that the issues identified that lead to Recommendation One (1) were addressed by Policy Bulletin 18-08 issued in July 2018, though the state auditor disagrees. DGS plans on implementing Recommendations Two (2) and Three (3), and believes that it had already implemented Recommendation Four (4) in July 2018 through the issuance of several policy bulletins. For Recommendation Five (5), DGS agrees that the issue raised by the auditor has merit, but instead recommends that lease payments be consolidated to CalVet to simplify the process.

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While there are technical points in the report that DGS disagrees with, the state auditor repeatedly notes that the lack of documentation in these lease files (particularly for the older leases) made it difficult to accurately state what DGS did or did not do in executing the leases. DGS is in full agreement and has accordingly issued a policy bulletin to address file documentation moving forward.

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DGS will continue to seek every opportunity to improve its oversight of the leasing of state property and provide enhanced guidance to state agencies.

RECOMMENDATIONS

[Redacted] DGS Mismanaged Veterans Home Property by Entering Into Agreements That Do Not Align With State Law or the Interests of the Veteran Residents:

RECOMMENDATION # 1: *To ensure that leases of veterans home property comply with state law and are consistent with the veterans homes' mission to serve the veteran residents, by June 2019 DGS should adopt, in consultation with CalVet, a definition of what constitutes the best interests of the veterans homes and begin incorporating that definition into the State Administrative Manual. DGS should deny any requests for leases that do not meet those criteria. When leasing veterans home property, DGS should document its reasons for determining that the terms of the lease are in the best interests of the home.*

DGS RESPONSE # 1:

DGS fully agrees that leases let under Military and Veteran's Code Section 1023 must be in the best interest of the Veteran's Home and that leases let by DGS should be in the best interests of the state. DGS further agrees that the explanation as to how leases are in the best interests of a home or the state should be well documented in the lease file and enshrined in the lease itself in the recitals. To this end, DGS issued RESD Policy Bulletin 18-08 in July 2018. This policy bulletin requires that departments provide DGS with a justification as to how the proposed lease is appropriate to their mission and scope of responsibility (or provides a broad public benefit), which is vetted by DGS. If approved, the lease will move forward, and the statement of benefit is required to be noted in the lease recitals. DGS believes that this process, written as a singular policy for all lease transactions, covers the auditor's recommendation.

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Marybel Batjer

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January 14, 2019

RECOMMENDATION # 2: *To ensure that all leases of veterans home property protect the interests of the State and the homes, DGS should review the lease that is void under state law and any that do not meet its criteria for being in the best interests of the veterans homes. DGS should attempt to reach new agreements with these lessees that address these areas of noncompliance and concern.*

DGS RESPONSE # 2:

DGS and CalVet will work together to identify leases that are voidable or contain unfavorable terms and, where appropriate, terminate or attempt to renegotiate the terms.

RECOMMENDATION # 3: *To remind state entities about the requirements for agreements that convey an interest in state property, by June 2019 DGS should issue guidance about DGS's approval authority for such agreements.*

DGS RESPONSE # 3:

By June 2019, DGS agrees to issue a formal reminder for state departments regarding DGS' role and leasing authority.

RECOMMENDATIONS

[Redacted] DGS Has Inadequately Overseen Rental Fees and Payments, Reducing the Funds Collected and Reinvested for the Benefit of the Veterans:

RECOMMENDATION # 4: *To ensure that it can justify the rental rates it approves, DGS should document its assessment of market value and market rent for all veterans home property leases before leasing the property. It should set rental rates equivalent to fair market rent in all cases except those in which it accepts improvements to the property or services to the veterans in exchange for reduced or waived rent. In the case of reduced or waived rent, DGS should document a calculation of the value of the property improvements or services and reduce the rent by an amount equal to the calculated values.*

DGS RESPONSE # 4:

- ② To better document standing policy, DGS issued RESD Policy Bulletins 18-04, 18-05, and 18-06 in July 2018. These Bulletins describe DGS policy on the establishment of rental rates at and below fair market value, and use of in-lieu benefits. To ensure that there is a clear rationale for rental rates and demonstrated compliance with the bulletins, DGS' State Owned Leasing and Development (SOLD) lease files will document the methodology used to establish the rental rate and/or associated reductions for in-lieu benefits (ex: capital improvements to the property or services rendered to the State that would otherwise be paid for by the State).

Marybel Batjer

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January 14, 2019

RECOMMENDATION # 5:

To comply with state law, DGS should begin depositing lease payments from leases of veterans home property into the General Fund so that those funds may be used to augment the appropriation of the veterans homes, and should reimburse the General Fund for the amounts it inappropriately deposited into the property acquisition law money account. DGS should also notify the Department of Finance and the Legislature annually of the amount of lease payments it collects to ensure that those proceeds are appropriately directed to the veterans homes.

DGS RESPONSE # 5:

DGS agrees that funds for leases let under Military and Veteran's Code Section 1023 should be made available to the applicable veterans home. At this time, DGS' ability to code lease payments to the General Fund is limited. Further, DGS cannot deposit funding into the General Fund that could be accessed by CalVet. As such, DGS plans to reach out to CalVet to discuss having all lease payments centralized with CalVet to avoid the need for annual augmentations. Additionally, centralizing the payments to CalVet would allow for more timely and better tracking of the lease payments.

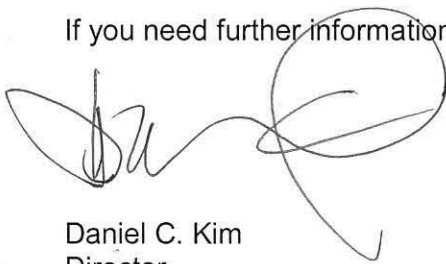
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CONCLUSION

DGS is firmly committed to ensuring that leased property is in compliance with state law and is in the best interests of the veterans homes, while protecting the interests of the State. As part of its continuing efforts to improve those processes, DGS will take appropriate actions to address the issues presented in the report.

If you need further information or assistance on this issue, please contact me at (916) 376-5012.



Daniel C. Kim
Director

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COMMENTS

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM THE DEPARTMENT OF GENERAL SERVICES

To provide clarity and perspective, we are commenting on DGS's response to the audit. The numbers below correspond to the numbers we have placed in the margin of its response.

As DGS notes in its response, we disagree with its belief that its July 2018 policy bulletin fully addressed the issues we identified regarding its process for ensuring that leases of veterans home property are in the best interests of the home. As we discuss on page 11, DGS has not defined how it will determine whether lease agreements are in the best interests of the home which, as we describe on page 13, is a specific requirement for leases of veterans home property. The policy bulletin DGS refers to describes its general process for leasing state property and requires the agency with jurisdiction over the property to describe the benefits of entering into the lease. However, as we state on page 13, the presence of one or more benefits does not necessarily mean that a lease is in the best interests of a veterans home. Therefore, because DGS's policy bulletin does not include a definition of what those best interests are, it does not address our concerns. Without this definition DGS cannot act in the oversight role that state law assigns to it. We would expect that DGS would fulfill its responsibility under state law to review proposals for new leases of home property to ensure that they comply with state law; however, until DGS collaborates with CalVet to define what it means for a lease to be in the best interests of the home, it cannot adequately do so.

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Although DGS states that it has already implemented our recommendation concerning setting rental rates equivalent to fair market rent and documenting its justification for the rental rates it establishes, we disagree. We acknowledge on page 27 that in July 2018 DGS formalized its process for determining fair market value, but we found that DGS had not documented its fair market value assessment for most of the properties we reviewed. Until DGS begins documenting its assessment of market value and market rent before leasing veterans home property, it cannot demonstrate that it has fully implemented our recommendation.

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DGS argues that the lease payments for veterans home property should be consolidated to CalVet to simplify the process, and it further states on page 71 that doing so would allow for more timely and better tracking of lease payments. We did not share our findings regarding CalVet's lease payment tracking with DGS because our

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confidentiality requirements prohibit such disclosure until we publicly issue our report. However, we discuss on page 33 that CalVet failed to properly monitor and enforce rental payments. In addition, on page 36 we state that DGS already collects lease payments for several different state agencies and its payment tracking system is more robust than CalVet's, making it better able to track payments.

- ④ DGS mischaracterizes the sections of our report regarding its lack of documentation. Our report does not state that the lack of documentation in DGS's lease files made it difficult to accurately state what DGS did or did not do in executing the leases we reviewed. Instead, we report that DGS lacked documentation demonstrating that it met certain requirements in state law when leasing veterans home property. For instance, on page 27 we discuss that state law requires DGS to set rental rates at fair market rent, and we report that DGS could not demonstrate how it established fair market value for most of the leases we reviewed. Additionally, on page 11 our report indicates that state law authorizes DGS to lease veterans home property under terms and conditions that are in the best interests of the home, but that DGS had not defined how it would determine whether leases comply with that statutory requirement. We further state on page 13 that we found no evidence that DGS had documented any analysis of how it determined the leases we reviewed were in the best interests of the veterans home.
- ⑤ DGS appears to indicate that it would face some challenges in implementing our recommendation. As we discuss on pages 28 and 32, state law requires that the proceeds from most leases of veterans home properties be deposited into the General Fund to augment the appropriation that the homes receive. We further state that as a collector of lease payments for the properties, DGS has a responsibility to ensure the homes receive those proceeds. DGS has been collecting lease payments for leases of veterans home property for several years including the \$118,000 in lease payments it collected from July 2015 through June 2018. Consequently, we expected that DGS would have already been aware of and acting in compliance with the state law governing proceeds from those leases. We look forward to reviewing documentation that shows how DGS has taken steps to adhere to state law at the department's 60-day response to this recommendation.