

**PORT OF SEATTLE**  
**MEMORANDUM**

**COMMISSION AGENDA**  
**ACTION ITEM**

<b>Item No.</b>	<u>5d</u>
<b>Date of Meeting</b>	<u>March 18, 2014</u>

**DATE:** February 28, 2014  
**TO:** Tay Yoshitani, Chief Executive Officer  
**FROM:** James R. Schone, Director, Aviation Business Development  
Deanna Zachrisson, Manager, Concessions Business  
**SUBJECT:** Host International Settlement Agreement

**Total One-Time Payment to the Port:** \$311,931

**ACTION REQUESTED**

Request Commission authorization for the Chief Executive Officer to enter into a settlement agreement with Host International (Host) for certain unpaid concession rent on gross sales in its operations at Seattle-Tacoma International Airport (Airport).

**SYNOPSIS**

The proposed settlement agreement resolves a dispute between the Port and Host pertaining to one of three findings in a 2013 internal audit of a lease and concession agreement for food service operations at the Airport. Host did not dispute the other two findings and has satisfactorily addressed them. With respect to the disputed finding, Host has agreed to pay \$311,931. Since the settlement amount is greater than \$300,000, Commission authorization is necessary for it to be executed under the current provisions of the Port's Master Delegation of Authority, Resolution No. 3605, as amended by Resolution No. 3628.

**BACKGROUND AND JUSTIFICATION**

The Host lease and concession agreement encompasses a total of 24 food and beverage locations at the Airport. Eight of these locations are operated by subtenant Airport Concessions Disadvantaged Business Enterprise (ACDBE) businesses. In 2013, Host and its subtenants generated \$43.3 million in gross sales.

As is typical for food service agreements at the Airport, the operator pays a percentage of gross sales as rent to the Port. The percentage in these particular agreements depends upon the type of product sold such as alcohol, branded food and beverage, or non-branded food and beverage. The Host agreement was executed in 2003, near the end of the master concessionaire lease that Host held at the Airport. As a means of encouraging brand name concepts, the Port afforded 2% less percentage rent in the agreement for a branded concept rather than a generic, non-branded concept. The original 2003 lease did not provide specific criteria to define a branded vs. non-branded concept. However, an amendment to the lease in late 2005 added such a definition. To

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be considered a branded concept (or product), the lessee must pay at least 3% of gross sales to the franchisor or licensee for use of the brand name.

Port Internal Audit staff conducted an audit of the Host agreements for the period January 1, 2009, through December 31, 2011. Specifically in the Host agreement, audit staff found that one of Host's franchise concepts, Great American Bagel Bakery (GABB) did not meet the required 3% threshold to be considered branded food and beverage. Host paid only 2% in royalty to GABB, thus the franchise did not qualify for the 2% lower rent. In addition, a smaller discrepancy was discovered with regard to a Diva Espresso franchise location. In the latter instance, branded Diva Espresso beverages qualified as branded, while other food items should have been considered non-branded food at the higher rate. The amount that Internal Audit staff identified as owed for these issues is as follows:

<b>Total Underreported Concession</b>	
2009	\$121,514
2010	\$132,546
2011	<u>\$141,040</u>
<b>Total Additional Concession Due</b>	<b>\$395,100</b>
Late Charge (5% Per Agreement Terms)	\$19,755
Interest Accrued Through 9/30/2013	<u>\$220,849</u>
Subtotal	<b>\$635,704</b>
Cost of Audit	\$34,029
<b>Total Amount Due to Port</b>	<b>\$669,733</b>

All of the audit findings are summarized below, as reported to the Port Audit Committee on October 3, 2013:

**1) Host did not calculate rent payments correctly resulting in an additional \$395,100 owed to the Port.**

Host's Great American Bagel Bakery franchise did not fulfill the criteria to be considered "branded food and beverage." In addition, a smaller discrepancy was discovered with regard to a Diva Espresso franchise location. Including late penalties and accrued interest, the owed amount totals \$635,704. In addition, because the audit revealed a discrepancy of more than 2% of the concession fee owed for any 12-month period, Host is required to pay for the full cost of the audit. The cost of the audit was \$34,029.

**2) Host did not provide adequate documentation to substantiate gross sales as required by the agreement.**

The audit concluded that gross sales for an ACDBE subtenant with a location under the Host lease agreement (as well as under Host's Seattle Restaurants Associates lease agreement) were underreported. This was determined by examination of monthly reports that showed received

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amounts to be greater than reported. The effort to determine the cause of the discrepancies was hampered by the lack of required documentation to substantiate gross sales. For the sample period, the auditors determined that the amount owed to the Port including applicable late fees and interest is \$7,491. This amount is not included in the summary above as it has not been the subject of negotiation in this settlement.

### **3) Host did not provide accounting records and other documents in a timely manner.**

Port auditors experienced difficulties in securing financial information necessary to conduct the audit. Host was reluctant to allow auditors to examine franchise and/or license agreements as required. The ACDBE subtenant was uncooperative with the Port's and Host's requests for documentation.

### **Resolution of Audit Claims**

In response to the audit on the issue of branded food sales, Host maintained that the interpretation of the lease language specific to the definition of branded vs. non-branded food was unclear. By Host's interpretation, any payments to the concept franchisor should qualify toward meeting the 3% threshold – including specifically any payments for required purchases of branded product from the franchisor. The Port maintains that the 3% payment threshold is specific to royalty or licensing fees. In addition, Host pointed out that the GABB agreement was long-standing and had previously been reviewed by the Port with no exception taken. In addition, the parties recognized that the issue extended beyond the specific audit period, potentially through 2013. However, due to a revision in the agreement with GABB that was effective January 1, 2013, the issue only extended through December 2012. The settlement specifically encompasses all amounts through December 2012. With respect to Diva Espresso, the issue continued through 2013.

In the proposed settlement of the GABB issue, Host will pay one-half of the principal amount identified by Internal Audit staff. Host also will pay the cost of the audit. However, the Port will forego the remaining portion of the principal amount, interest, and late fees. In doing so, the Port accepts some responsibility for failing to identify this issue earlier with Host. Logically, if Host had understood that a 3% royalty was required to qualify as a branded concept, Host would likely have paid GABB this additional 1% rather than pay the Port an additional 2% in percentage rent.

In the proposed settlement of the Diva Espresso issue, Host will pay the discrepant amount in full and additionally amounts owed for 2012-2013. Host is aware that it must also pay accrued state Leasehold Excise Tax of approximately \$25,000, which is not included in the settlement amount.

This proposed settlement was presented to the Port's Audit Committee on February 4, 2014.

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### **Proposed Settlement**

The negotiated settlement is summarized in the table below:

<b>Total Amount Owed to Port</b>	
GABB Underpaid Rent 2009-2011	\$192,590
Diva Espresso Underpaid Rent 2009-2011	\$4,960
Cost of Audit	\$34,029
Underpaid Rent GABB 2012	\$70,821
Underpaid Rent Diva 2012-2013	<b>\$9,531</b>
<b>Total Amount Due to Port</b>	<b>\$311,931</b>

The proposed settlement agreement accompanies this memo.

### **ALTERNATIVES AND IMPLICATIONS CONSIDERED**

**Alternative 1)** Do not approve the proposed settlement agreement. Under this alternative, staff would need to pursue the Port's claims in court. Considering the likely transaction costs associated, it is uncertain that this course would lead to a better net outcome for the Port. This is not the recommended alternative.

**Alternative 2)** Approve the proposed settlement agreement. This alternative leads to a reasonable recovery of underpaid rent that will conclude this matter with Host. Host acknowledges the Port's interpretation of the branded food and beverage franchise fee criteria and is now in compliance with this interpretation. The settlement also accounts for the Port's role in not identifying this issue in an earlier audit. **This is the recommended alternative.**

### **ATTACHMENTS TO THIS REQUEST**

Exhibit A: Proposed settlement agreement

### **PREVIOUS COMMISSION ACTIONS OR BRIEFINGS**

- February 4, 2014: Port of Seattle Audit Committee briefing on the proposed settlement agreement with Host.
- October 3, 2013: Port of Seattle Audit Committee briefing on the internal audit of Host and Seattle Restaurant Association's leases with the Airport.