LSC

Legal Services Corporation
Office of Inspector General

April 22, 2005

To the Board of Directors
Legal Services Corporation

Report on the Financial Implications of the 3333 K Street Lease

At the February Legal Services Corporation (LSC) Board of Directors' meeting, I briefed the Board on the financial implications of the 3333 K Street, NW, lease that was entered into by the previous LSC Board of Directors and previous LSC President in 2002. The OIG conducted this review after hearing concerns from Congress and OIG staff as well as members of LSC management.

This report transmits to you two recent independent appraisal reports that assessed the lease as well as information on other costs related to the lease at, and the move to 3333 K Street. This report contains no recommendations but rather is being provided to assist the LSC Board in determining any future actions. The following is a brief summary of the appraisers' reports and OIG's conclusions. To fully understand their conclusions, I recommend that you read both appraisers' reports.

CONCLUSION

Based on the two attached appraisal reports, the OIG calculates LSC will overpay between $1.23 million and $1.89 million in rent over a 10-year period as a result of paying above market rent, depending upon the degree to which LSC actually received an above market tenant improvement allowance.[1] Two Washington, D.C., based commercial real estate appraisal firms (Joseph J. Blake & Associates and MillenniuM Real Estate Advisors) independently found that LSC pays above market rent for its lease at 3333 K Street. Based on information provided by the appraisers, the OIG calculated that LSC could have saved at least $680,000 over a 10-year period by remaining in its existing space at 750 First Street, NE. Also, LSC would not have incurred $440,000 in costs

[1] As a result of management comments, OIG recalculated the estimated overpayment under two scenarios, one giving full credit for the unusually high tenant improvement allowance, and one using a more normal tenant improvement allowance. The $1.23 million assumes that LSC would receive the full $2 million tenant improvement allowance.

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associated with the move. In addition, the OIG calculated that LSC may be due a rent credit because it was charged for 45,000 square feet when it only occupied 42,852 square feet from June 2003 until very recently.

BACKGROUND

In 1998, LSC began pursuing the idea of purchasing its own building in order to provide LSC with higher visibility and a sense of permanence. LSC believed a permanent home would also cap LSC's future occupancy costs. In 2001, the Bill and Melinda Gates Foundation offered $4 million to partially fund the purchase of a permanent headquarters for LSC. In April 2001, at the suggestion of outside advisors, key members of LSC established a supporting organization—the Friends of the Legal Services Corporation (Friends)—to make such a purchase.[2] One of the stated goals in Friends' Articles of Incorporation is to acquire, hold and manage assets for use by LSC where doing so may result in lower costs or greater efficiencies for LSC.

On July 2, 2002, Friends purchased a 5-story, 60,000 square foot commercial office building located at 3333 K Street. The day before, July 1, 2002, LSC entered into a 10-year lease agreement with Friends for 45,000 square feet of office space and 50 parking spaces at the property. (The lease term actually began on June 1, 2003 when LSC occupied the space.) LSC agreed to pay $1.71 million per year for 45,000 square feet, the equivalent of $38 per square foot, for the entire lease term, plus $100 per month per space for 50 parking spaces. (LSC subsequently acquired two additional parking spaces at the same rate.) LSC did not pay a security deposit and pays no annual pass through costs such as electricity. The lease agreement provides that Friends pay up to $2 million in build out costs for LSC's office space[3]. The lease does not contain a renewal option, nor does it provide for the ownership of the building to pass to LSC.[4] The lease also specifies that in the event the mortgagor, Bank of America, forecloses on the building LSC must continue to pay rent for the duration of the lease.

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[2] Since its inception, Friends has altered its Board composition in such a manner that neither LSC nor key members of LSC retains control of Friends. Furthermore, in the recent past Friends began taking calculated measures to gain distance and independence from LSC. Currently, the actual relationship between Friends and LSC is unclear.
[3] This is an atypical tenant improvement clause because unspent tenant improvement funds, if any, are to be returned to the landlord. Traditional tenant improvement clauses are dollar certain because any unspent tenant improvement allowances are transferred to the tenant as rent credits.
[4] Friends' current charter states that if Friends ceases to exist and after Friends' liabilities are extinguished, then Friends' remaining assets will be turned over to LSC.

METHODOLOGY

The OIG hired two Washington, D.C., based commercial real estate appraisal firms to evaluate the lease. The appraisers worked independently of one another and each represented that it conducted its work in accordance with the appraisal industry's professional ethics and standards. The appraisers had access to documents pertaining to the leases of 3333 K Street and 750 First Street that LSC and Friends provided to the OIG pursuant to an OIG document request. The OIG held one joint meeting with the appraisers to ensure that both had the same understanding of the questions to be answered. No specifics of the appraisals were discussed in the joint meeting. Each appraiser was asked to answer the same series of questions designed to help the OIG determine whether LSC pays fair market rent at 3333 K Street and whether LSC saved money by moving from 750 First Street. The OIG also wanted information as to whether there were intervening market factors that arose between July 2002, when the lease was signed, and November 2004, when the appraisals began, that could impact the assessment. Additionally, the OIG reviewed available documentation related to the number of square feet actually occupied by LSC and to the costs of relocating to 3333 K Street.

SUMMARY OF APPRAISERS' FINDINGS

Both appraisers concluded that LSC's rent exceeded the market rate at 3333 K Street. Based on the appraisers' reports, the OIG calculates that LSC will overpay between $1.23 and $1.89 million dollars over the 10-year lease.

Blake Appraisal

Based on Blake's analysis, the OIG calculates that LSC will pay between $1.38 and $1.89 million above market rent over the 10-year lease depending upon the degree to which LSC actually received an above market tenant improvement allowance[5]. These calculations are in Appendix A. The OIG calculates LSC has already overpaid at least $650,000 through January 2005. LSC will continue to pay above market rent for the space it is occupying until at least June 2010. The

[5] The Blake report found that LSC's tenant improvement allowance was $10 per square foot above market, for a long-term (10-year) lease, which could require market rates be adjusted upward by $1.00 per square foot per annum. Because of the atypical tenant improvement clause in the LSC lease, it was not known as of July 1, 2002, whether LSC would receive the full value of the tenant improvement allowance. Thus, there would be no way to determine with certainty the impact that the tenant improvement allowance would have on market rent on July 1, 2002. As a result, the OIG performed two calculations, one of which assumed that LSC received the full value of the $2 million tenant improvement allowance and one that assumed a typical tenant improvement allowance. The first calculation included an upward adjustment of $1.00 per square foot per annum in market rent to Blake's average market rent calculation of $26.42 for July 2002. The second calculation used Blake's average market rent figure of $26.42. However, because LSC did not start paying rent until June 2003, the OIG used Blake's assumptions in its chart on page 83 to determine total rent costs from June 2003 to May 2013 under both scenarios.

savings LSC will realize in the last years of the lease term will not offset LSC's overpayment during the first seven years of the lease.

LSC will realize greater annual savings from 2013 on out, assuming that LSC can obtain a lease extension at the same rate of $38 per square foot with no pass through costs and below market prices for parking spaces. However, it will still take several years beyond 2013 before LSC recoups the overpayment on the original lease. The OIG is concerned that Friends has proposed a lease extension with less favorable terms than the current lease, in that LSC would pay pass through costs beginning in June 2013. This proposal could reduce or perhaps even eliminate any such future savings.

Blake also concluded that LSC's rent is higher than the rents of the other tenants in the building and is therefore less favorable to LSC.

MillenniuM Appraisal

Based on MillenniuM's analysis, the OIG calculated that LSC will overpay between $1.23 and $1.74 million in above market rent over the 10-year lease term, again depending upon the degree to which LSC actually received an above market tenant improvement allowance. These calculations are at Appendix B.

Although MillenniuM did not include the kind of 10-year chart provided by Blake, the OIG determined that under MillenniuM's assessment the average rental rate LSC should have paid in June 2003 is either $27.38 or $28.40, depending on whether there is a $1.00 per square foot adjustment for the $2 million dollar tenant improvement allowance. MillenniuM estimated a market target rate of $25.50 per square foot in July 2002 and then adjusted that rate by floors (see pages XI-2 and XI-3). MillenniuM did not calculate an average rate for the space LSC occupied. The OIG determined the average rental rate by using Millennium's per floor rates and applying it to 45,000 square feet that LSC leased.[6] Applying Blake's formula to develop the market rent for 3333 K Street, the OIG calculates the LSC will overpay between $1.23 and $1.74 million over the 10-year lease depending on whether LSC received the full benefit of the $2 million tenant improvement allowance.

Based on the above, the OIG calculates LSC has already overpaid by at least $635,000 through January 2005. LSC will continue to pay above market rent for the space it is occupying until at least June 2010. The savings LSC will realize in the last years of the lease term will not offset LSC's overpayment during the first seven years of the lease.

As with the Blake analysis, LSC will realize greater annual savings from 2013 on out, assuming that LSC can obtain a lease extension at the same rate of $38 per

[6] Because Millenium used 42,852 square feet, the OIG added 2,148 square feet to the fourth floor to equate to 45,000 square feet, the same square footage that Blake's numbers were based on.

square foot with no pass through costs and below market prices for parking spaces. It will also take several years beyond 2013 before LSC recoups the overpayment on the original lease.

MillenniuM also concluded that LSC's lease was less favorable than the leases of the other tenants of 3333 K Street.

2004 Market Conditions
Both appraisers determined that as of November 2004, LSC's lease is less favorable than those of the other tenants at 3333 K Street, including new leases let with other tenants since LSC moved into the building. The appraisers also found that LSC's lease is less favorable than the leases of comparable rentals in the Georgetown area. Thus, the appraisers found that the changes in the Georgetown rental market did not alter their conclusions that LSC is paying above market rent for its space at 3333 K Street.

No Financial Benefit in Moving from 750 First Street
Both appraisers found that the 10-year cash outlay would have been less if, in 2002, LSC had stayed in the existing space of approximately 40,000 square feet at 750 First Street, a Class A building near Capitol Hill, instead of leasing 45,000 square feet of space at 3333 K Street, a Class B building in Georgetown.

Blake stated that the aggregate cost of LSC's existing space at 750 First Street for a 10-year lease would have been about $17 million; while LSC's 10-year costs at 3333 K Street are about $17.7 million or $680,000 more (see pages 138-141).[7] MillenniuM stated that the LSC gross tenant cash outlay for 3333 K Street is $17.7 million while a similar outlay at 750 First Street would have been $16.1 million, a difference of $1.6 million (see page 3).[8] The appraisers' numbers also do not take into account the $440,000 in un-reimbursed costs associated with the move to 3333 K Street, discussed below.

LSC Incurred an Additional $440,000 Cost by Moving from 750 First Street

As discussed above, in addition to the lease costs, the OIG identified approximately $440,000 in moving costs incurred by LSC. The moving costs include the build out of the OIG's space, furniture purchases, moving vans and labor, a security system, and wiring.

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[7] According to Blake, when both are compared based on the same square footage of leased area and the same number of parking spaces, the lease at 3333 K Street costs less than a lease at 750 First Street.

[8] MillenniuM also stated that if tenant improvement allowances are included, the net tenant outlay for 3333 K Street is $346,000 less than the net outlay would have been at 750 First Street. Because the gross tenant cash outlay represents the total amount of actual appropriated funds that LSC would have spent on rent at 750 First Street and will spend on rent at 3333 K Street, the OIG believes that the gross tenant cash outlay is the better methodology to assess whether the move was financially beneficial.

Potential Rent Credit

LSC's lease is for 45,000 square feet, but a re-measurement in April 2004 confirmed that LSC had been occupying only 42,852 square feet. After some negotiation, LSC and Friends devised a solution to the disparity by providing additional space to LSC on the fourth floor to bring LSC up to approximately 45,000 square feet. LSC continued to pay Friends through October 2004 for the 2,148 square feet of space not provided until LSC started renovations on the fourth floor. The OIG estimates that LSC will have overpaid at least $115,000 from the start of the lease payments until the date LSC occupied the additional space.

The OIG is concerned that Friends' recent proposed lease amendment contains a proposal to credit LSC with $82,500 in build out costs instead of providing a rent credit for the entire period LSC did not occupy the space and paying for all build out costs.

Future Work

The OIG review of the lease at 3333 K Street raised a number of issues requiring additional OIG work. The OIG will initiate reviews in the following areas, as needed.

1. Whether there are factors other than total rent payments that make the leasing arrangement with Friends more favorable to LSC despite its overpayment for rent expenses.
2. Whether the amount of space currently leased is justified based on the amount of space needed for LSC to accomplish its mission.
3. Whether there were any conflicts of interest pertaining to LSC's relationship with Friends and if so whether they were dealt with appropriately.
4. Whether there were any breaches of fiduciary duty.

I will continue to keep the Board and the LSC President informed as this office conducts these reviews.

Kirt West

Kirt West
Inspector General

Enclosures: Blake Appraisal Report
MillenniuM Appraisal Report

OIG Calculations of Lease Overpayment Based on Blake's Appraisal (adjusted to 2003)

Calculations Without Adjustment for Tenant Improvement Allowance

Year	Annual Rent	Pass Thru	Adj Mkt Rent	LSC Rent	Difference (Mkt - LSC)	LSC Sq Ft	Annual Difference
2002 Base	$26.42						
Escalation	102.5%						
New Base	$27.08						
2003	$27.08	$0.00	$27.08	$37.31	($10.23)	45,000	($460,328)
2004	$27.76	$0.32	$28.08	$37.24	($9.16)	45,000	($412,312)
2005	$28.45	$0.64	$29.09	$37.18	($8.09)	45,000	($363,985)
2006	$29.16	$0.97	$30.13	$37.11	($6.98)	45,000	($313,977)
2007	$29.89	$1.32	$31.21	$37.05	($5.84)	45,000	($262,719)
2008	$32.39	$1.67	$34.06	$36.98	($2.92)	45,000	($131,319)
2009	$33.20	$2.04	$35.24	$36.90	($1.66)	45,000	($74,628)
2010	$34.03	$2.41	$36.44	$36.83	($0.39)	45,000	($17,476)
2011	$34.88	$2.80	$37.68	$36.75	$0.93	45,000	$41,959
2012	$35.75	$3.20	$38.95	$36.67	$2.28	45,000	$102,802
Total Projected Overpayment							($1,891,981)

Calculations Adjusted for $2 Million Tenant Improvement Allowance

Year	Annual Rent	Pass Thru	Adj Mkt Rent	LSC Rent	Difference Mrkt - LSC	LSC Sq Ft	Annual Difference
2002 Base	$26.42						
T.I. Adj	$1.00						
Adj Base	$27.42						
Escalation	102.5%						
New Base	$28.11						
2003	$28.11	$0.00	$28.11	$37.31	($9.20)	45,000	($414,203)
2004	$28.81	$0.32	$29.13	$37.24	($8.11)	45,000	($365,034)
2005	$29.53	$0.64	$30.17	$37.18	($7.01)	45,000	($315,525)
2006	$30.27	$0.97	$31.24	$37.11	($5.87)	45,000	($264,305)
2007	$31.02	$1.32	$32.34	$37.05	($4.71)	45,000	($211,805)
2008	$33.52	$1.67	$35.19	$36.98	($1.79)	45,000	($80,405)
2009	$34.36	$2.04	$36.40	$36.90	($0.50)	45,000	($22,442)
2010	$35.22	$2.41	$37.63	$36.83	$0.80	45,000	$36,015
2011	$36.10	$2.80	$38.90	$36.75	$2.15	45,000	$96,788
2012	$37.00	$3.20	$40.20	$36.67	$3.53	45,000	$159,001
Total Projected Overpayment							($1,381,916)

APPENDIX B

OIG Calculations of Lease Overpayment Based on MillenniuM's Appraisal (adjusted to 2003)

MillenniuM Appraisal Without Adjustment for Tenant Improvements

Year	Annual Rent	Pass Thru	Adj Mkt Rent	LSC Rent	Difference (Mkt - LSC)	LSC Sq Ft	Annual Difference
2002 Base	$26.71						
Escalation	102.5%						
New Base	$27.38						
2003	$27.38	$0.00	$27.38	$37.31	($9.93)	45,000	($446,951)
2004	$28.06	$0.32	$28.38	$37.24	($8.86)	45,000	($398,601)
2005	$28.76	$0.64	$29.40	$37.18	($7.78)	45,000	($349,931)
2006	$29.48	$0.97	$30.45	$37.11	($6.66)	45,000	($299,572)
2007	$30.22	$1.32	$31.54	$37.05	($5.51)	45,000	($247,954)
2008	$32.72	$1.67	$34.39	$36.98	($2.59)	45,000	($116,554)
2009	$33.54	$2.04	$35.58	$36.90	($1.32)	45,000	($59,494)
2010	$34.38	$2.41	$36.79	$36.83	($0.04)	45,000	($1,964)
2011	$35.24	$2.80	$38.04	$36.75	$1.29	45,000	$57,860
2012	$36.12	$3.20	$39.32	$36.67	$2.65	45,000	$119,100
Total Projected Overpayment							($1,744,062)

Calculations Adjusted for $2 Million Tenant Improvement Allowance

Year	Annual Rent	Pass Thru	Adj Mkt Rent	LSC Rent	Difference (Mkt - LSC)	LSC Sq Ft	Annual Difference
2002 Base	$26.71						
T.I. Adj	$1.00						
Adj Base	$27.71						
Escalation	102.5%						
New Base	$28.40						
2003	$28.40	$0.00	$28.40	$37.31	($8.91)	45,000	($400,826)
2004	$29.11	$0.32	$29.43	$37.24	($7.81)	45,000	($351,323)
2005	$29.84	$0.64	$30.48	$37.18	($6.70)	45,000	($301,471)
2006	$30.59	$0.97	$31.56	$37.11	($5.55)	45,000	($249,901)
2007	$31.35	$1.32	$32.67	$37.05	($4.38)	45,000	($197,041)
2008	$33.85	$1.67	$35.52	$36.98	($1.46)	45,000	($65,641)
2009	$34.70	$2.04	$36.74	$36.90	($0.16)	45,000	($7,308)
2010	$35.57	$2.41	$37.98	$36.83	$1.15	45,000	$51,527
2011	$36.45	$2.80	$39.25	$36.75	$2.50	45,000	$112,688
2012	$37.37	$3.20	$40.57	$36.67	$3.90	45,000	$175,299
Total Projected Overpayment							($1,233,997)

EVALUATION OF MANAGEMENT'S RESPONSE

The following is the OIG's evaluation of the Board's response to the OIG draft report. The Board's response can be found in its entirety in Appendix D.

The OIG's report is based on the work of two independent commercial real estate appraisers. These appraisers followed professional standards and considered appropriate factors, including expected rental rates over the term of the lease, the comparative cost of leasing other space, and potential market changes in Washington, DC, and its Georgetown submarket. The Board's response did not cause the OIG to change its conclusion that LSC is paying above market rent for its office space at 3333 K Street, NW. Based on the Board's response, however, the OIG decided to show this overpayment as a range that depends upon the degree to which LSC actually received an above market tenant improvement allowance. The OIG attempted to determine whether LSC had received the full benefit of the $2 million tenant improvement allowance. The OIG was unable to perform the work because LSC did not have records documenting whether the entire $2 million was used or how much was used.

The OIG has chosen not to respond to each management comment. The purpose of this report is to transmit the results of the professional appraisals and to provide information to the LSC Board for future decisions involving the LSC lease. The OIG believes that the comments, in many instances, misinterpreted or misread the results of the appraisals. We validated our calculations with Blake since the OIG applied Blake's assumptions to both Blake's and Millennium's determination of market rent. The OIG is confident in our calculations that LSC will overpay between $1.23 million and $1.89 million in above market rent.

LSC

Legal Services Corporation
America's Partner For Equal Justice

MEMORANDUM

TO: Kirt West, Inspector General

FROM: Frank B. Strickland, Chairman of the Board

DATE: April 20, 2005

SUBJECT: LSC Response to OIG Draft Report on the Financial Implications of the 3333 K Street Lease

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Attached is the revised LSC response to the OIG draft report. As you know, the response was approved unanimously by the Board of Directors in a notational vote in March.

Legal Services Corporation
America's Partner For Equal Justice

RESPONSE

OF THE

LEGAL SERVICES CORPORATION

TO THE

OFFICE OF THE INSPECTOR GENERAL REPORT

ON THE FINANCIAL IMPLICATIONS OF THE 3333 K STREET LEASE

April 20, 2005

NOTE: LSC has prepared this response based on the draft report prepared by the Office of the Inspector General. LSC did not see the final report prior to its release.

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The Corporation has prepared this response to the Office of the Inspector General's draft lease report. At the outset, we note that the OIG report is not final. The report concludes by stating that there are a number of issues requiring additional OIG work, including an assessment of "[w]hether there are factors other than total rent payments that make the leasing arrangement with Friends more favorable to LSC … ."[1] We believe those other factors are considerable and will further validate the Board's decision in 2001-2002 to undertake the move of its existing headquarters from First Street.

By way of background, the memorandum of understanding to purchase the K Street property was signed on March 21, 2002, the lease executed on July 2, 2002, and the property acquired on July 3, 2002, and LSC took occupancy on June 1, 2003. We note that all but two members of the LSC Board of Directors and most of senior management had no involvement with the creation of Friends of LSC, the decision to purchase a building, or the leasing of space at 3333 K Street.[2]

While current leadership of LSC has had no involvement in the lease negotiations, the last two Presidents of LSC (John McKay, now U.S. Attorney for the Western District of Washington, and former Illinois Congressman John Erlenborn), and the prior Board of Directors spent many hours discussing this matter and many months working on it.[3] Those officers and directors made a business decision after considering many factors, only one of which was cost, to enter into the K Street lease. They have as yet had no opportunity to review and comment on the draft report.

In its main points, the draft OIG report purports to establish that (1) LSC overpaid for the 3333 K Street

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[1] OIG draft report, p. 10.

[2] Seven members of the present Board were sworn into office on April 25, 2003, and one on July 24, 2003. The current LSC President took office on January 20, 2004 and the current Inspector General began on September 1, 2004.

[3] During this 2001-2002 period, the OIG was represented at every Board meeting and virtually all internal LSC planning meetings where the transaction was discussed. In addition, the OIG at its request received a private briefing from Friends' financial advisors regarding the details of the transaction. The OIG did not once raise any concerns regarding this matter with the LSC Board or management.

facility relative to its former First Street space, and (2) overpaid for K Street relative to fair market value. LSC believes that the OIG has failed to substantiate these findings. The assumptions underlying the OIG's draft report and these alleged findings will now be examined.

1. The appraisals are not comprehensive and thus are not meaningful in determining whether LSC's decision was a commercially sound transaction and a good business decision.

The OIG apparently instructed both appraisers to prepare an estimate of real estate values as of July 2002. Yet, as the Blake appraisal states (see p. 15), "a retrospective value estimate is most frequently utilized in connection with appraisals for state tax, condemnation, inheritance tax and similar purposes." Those are of questionable relevance to the wisdom of LSC's lease because they do not account for market factors in effect during the term of the lease.

Whether or not a lease is a commercially wise arrangement and was fiscally appropriate depends on a variety of factors including expected rental rates over the term of the lease and the comparative cost of leasing other space. Picking a point in time eleven months before LSC occupied the 3333 K Street space and began to pay rent, just because LSC signed the lease agreement on that particular day, on which to determine valuation of a ten year lease is difficult to understand or justify because it creates a distorted view of a lease running from 2003 to 2013.

The appraisals, apparently on instructions from the OIG, do not consider potential changes in the market for office space in Washington DC or its Georgetown submarket. The appraisals also did not, and maybe could not, consider all the financial and non-financial issues reviewed by the Board that might have made the K Street transaction desirable even if a slightly higher rent may have been paid in the first couple of years of the lease. The conclusions drawn from the appraisals by the OIG also do not correctly factor in tenant improvements made to the building at the landlord's expense.

The most useful comparison for evaluating the wisdom of the K Street lease is the alternative cost of leasing space for the period of June 2003 through May 2013 using realistic and updated market information and assumptions. LSC management considered commissioning such a current appraisal that would take into account and evaluate the various factors addressed herein, but concluded it would be unnecessary to do so.

2. <u>The appraisals actually demonstrate that the leasing arrangement is favorable to LSC relative to the cost of remaining at 750 First Street</u>.

Although both appraisals note that the initial rent at K Street is higher than the estimated rent for 750 First Street, both appraisals show that there is a "cross-over" effect in the third year of the lease at which point the K Street rent, which is fixed, becomes relatively lower with the differential becoming increasingly advantageous in each succeeding year over First Street. The Blake report estimates that LSC's rent (including pass-throughs) beginning July 2005 at the First Street location would be $38.61 per square foot, while the MilleniuM report estimates LSC's rent would be $38.10. Yet, LSC is paying $38.00 for its current headquarters. LSC's rate at 3333 K Street is fixed through May 2013, while the First Street lease contained both annual base rent increases and a building operation pass-through, standard clauses in Washington commercial leases.

In addition, the difference would continue to grow, with Blake estimating LSC's effective rent at First Street would have increased to $47.44 in 2012 and MilleniuM estimating it would rise to $42.89 at that time. LSC will still be paying $38.00 at K Street. The LSC lease for the First Street property, however, was to expire in 2007. We can only speculate what the rent adjustment and annual escalation factor might be after 2007. It is a reasonable assumption even at this date that these likely will be higher than the rates reflected in the projections upon which the appraisers made their calculations. Certainly operating on such an assumption in 2002 was appropriate.

LSC is also paying $100 per month per parking space for 52 spaces, for an annual cost of $62,000. A comparison of three commercial garages within two blocks of 3333 K Street found current rates of $215 to $226 per month for unreserved parking spaces. According to the appraisals, in 2002 LSC was paying $140 per month at First Street for 25 spaces for a total of $42,000 annually. The building owner could raise that fee at any time. As with the rent, LSC's $100 per month cost at K Street is fixed for the entire ten year life of the lease.

The Blake report acknowledges that LSC's current leasing arrangement is cheaper than First Street when factoring in the additional space and parking (see OIG draft report, footnote 7 and Attachment I).[4] Even accepting all the assumptions used in the Blake report as valid, the effect, according to Blake, is that LSC acquired 5,000 square feet of space and 27 parking spaces for only $68,000 per year or a total of $680,000 over the ten years.[5]

The MilleniuM estimate assumes no base rent increase beyond 2.5 percent per year through 2013 at First Street and no parking fee increase during the entire ten year period. Those assumptions are unrealistic, considering that a lease remained to be negotiated in 2007 for this office space on Capitol Hill where pricing is currently at a premium. Even so, and also without adjusting for the additional space and parking, MilleniuM concludes that the net cost to LSC of the K Street lease is less than what would have been paid at First Street when the value of the build-out is factored in, $15.7 million and $16.1 million, respectively.[6] The OIG draft report dismisses this conclusion in a footnote (see OIG draft report, footnote 8), focusing instead only on the alleged gross cost difference of $1.6 million.

3. **The OIG report ignores the fact that the prior LSC management had concluded in 2001 that the Corporation needed additional space.**

Prior LSC management and the previous Board concluded, after a study involving outside consultants,

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[4] Blake report, p. 3.
[5] Using a conservative fair market valuation of $200 per month per parking space, the 27 parking spaces by themselves are worth $64,800 annually.
[6] MilleniuM report, p. 3, table.

that LSC required more space than the 40,000 square feet it was occupying at First Street. The cost of LSC leasing additional space at First Street, assuming space was available there, along with any build-out costs associated with such space are overlooked in the draft OIG report.

Even after incorporating questionable assumptions regarding future rent and parking costs and denying LSC any credit for the $2 million build-out, the most the OIG report supports is that in moving from First Street to K Street, for an average annual cost of $68,000 (Blake) or $160,000 (MilleniuM), LSC obtained an additional 5,000 square feet of office space and 27 additional parking spaces. Most objective observers would consider either figure to be fiscally sound.

4. <u>The draft OIG report's conclusion that LSC will pay $1.23 to $1.89 million over the market rate for the ten year life of the lease is predicated on erroneous assumptions</u>.

The conclusion in the OIG draft report that LSC is paying over market rates appears actually to have been reached by the OIG using assumptions that are incorrect and do not properly take into account the rental history of the building. Neither appraiser reached the OIG's conclusion or endorsed the OIG's apparent methodology.

First, the $1.89 million overpayment estimate "credited" to the Blake report is derived in part from the average rent paid by other tenants at 3333 K Street as of mid-2002. In fact, the basic assumption, that the average rent paid by those tenants at that time constituted the full fair market rate, is incorrect. Due to unusual circumstances involving the previous owner of the building, it was the view of Friends' real estate advisors at the time of the transaction that 3333 K Street was encumbered by below-market leases.[7]

Those tenants had leases which pre-dated Friends' purchase of the building. Many of the leases had been in effect for some time, one as far back as 1994, and were

[7] The Blake report notes that the asking rents for the building were at the time less than Blake's assessment of fair market value. See Blake report, p. 79.

for small, oddly-configured, difficult to lease, niche or inferior space.[8] In the Washington DC commercial real estate market, a party seeking a new lease for 45,000 contiguous square feet will not, upon taking occupancy, get the same rental rate as a niche tenant who signed a lease *nine* years earlier.

Second, the LSC lease provided for tenant improvement concessions of up to $44 per square foot, which the Blake report acknowledges was $9 to $19 above the typical packages of the day. The total concessions LSC received were up to $2 million in tenant improvements, $400,000 to $850,000 more than normal market contracts provided. The comparable rent from the Blake report assumes just $15 per square foot in tenant improvement concessions. The difference between that and $44 per square foot is $1.3 million, nearly 70 percent of the OIG's estimate of LSC's alleged overpayment. The OIG's calculation of the alleged overpayment does not correctly take that into account.[9]

Third, the OIG's calculation presumes that the average rent charged other tenants at 3333 K Street will increase by only 2.5 percent annually. That assumption is already incorrect based on the leases in the property that have been renewed or renegotiated since mid-2002.[10] In addition, as the Blake report notes, most long-term commercial leases in the Washington DC market after the fifth year have an upward rate adjustment above the

[8] The leases in question took effect in 1994, 1995, 1996, 1997, 1998, 2000, and 2002.

[9] The OIG draft report offers an alternative calculation under which LSC's alleged overpayment is only $1.38 million, based on the assumption that LSC's tenant improvement package was $10 per square foot above the market. In fact, however, in determining estimated fair market rent for the K Street property, the Blake report assumed $15 per square foot in tenant concessions, $29 below what LSC received. (See Blake report, p. 80.)Thus the $500,000 adjustment is insufficient.

[10] Friends has placed a premium on *renewing* leases with existing tenants to avoid build-out and marketing costs. While the terms for the renewed leases have included rent increases substantially over 2.5 percent, the average rent paid by other tenants in the building appears still to be below the full market prices. However, Friends is attempting to bring the lease rates up to full market value as soon as is practicable as leases are renewed or renegotiated.

annual 2.5-3.0 percent inflation and pass-through increases.[11]

Fourth, the OIG's calculation assumes that the market price for each parking space is $150 per month and will increase by only 3 percent a year. As noted above, this assumption may not even withstand cursory review given the rates currently charged for comparable parking in Georgetown. Changing the initial estimated market price for each parking space to $200 per month would reduce the alleged overpayment by more than $325,000.

The $1.75 million overpayment estimate, which the draft OIG report ascribes to MilleniuM, suffers from all the same errors.

5. The draft OIG report does not address any benefit that may have accrued to LSC by virtue of the move.

A final analysis of the wisdom of LSC's move to K Street must take into account the benefits of the particular space to LSC given the needs and mission of LSC. The draft OIG report, in identifying future work, raises as an issue "[w]hether there are factors other than total rent payments that make the leasing arrangement with Friends more favorable to LSC…."[12]

Such an assessment is an essential part of the analysis and appropriately should be completed before any report is finalized and released publicly. Benefits accruing to LSC requiring review include at least:

- Adequate, contiguous space for LSC staff;

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[11] See Blake report, pp. 46, 76 and 79. According to Blake, the typical increase is $2.50 per square foot.

[12] On March 10, 2005, LSC management received a Draft and Confidential document from the OIG entitled "Audit of LSC's Two Million Dollars ($2,000,000) Landlord Contribution," in which the OIG requests that LSC Management "Obtain a full and detailed account from FoLSC of all costs associated with the $2 million landlord contribution" and that it "Conduct a detailed analysis of the costs to determine the reasonableness of these expenditures." This request further demonstrates that the OIG's evaluation of the LSC lease is incomplete. Until the analysis of the non-monetary benefits to LSC of the lease and the analysis of the value of the tenant improvements are completed, the delivery of a report on the lease by the OIG is premature.

- Increased efficiency by having office space specifically designed to meet LSC's needs;

- Stabilizing LSC's cost of space for ten years with indisputable, substantial long-term savings when a new lease for the building is signed;

- The ability to flexibly adjust to projected demand for space, especially taking into account a dramatically different budgetary environment than LSC was facing four or five years ago;

- The intangible and tangible benefits to LSC of having its own headquarters, rather than being a tenant in a building, an issue seriously considered and a conclusion reached by the previous Board and Presidents;[13] and

- The long-term gains of having a nonprofit landlord which was specifically created, and whose charter provides as its purpose, to benefit LSC and support its mission of delivering legal services to the poor.

With respect to this last point, the OIG suggests that a subject requiring a future review is "whether there were any conflicts of interest pertaining to LSC's relationship with Friends …." There is no question that Friends of LSC was created by LSC for the specific purpose of purchasing and operating a building on behalf of LSC.[14] The relationship between LSC and Friends was fully disclosed and widely known.

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[13] The desire for a national home for the Legal Services Corporation was the motivating factor of the Bill and Melinda Gates Foundation in making the significant grant which made the purchase of the 3333 K Street building possible.

[14] The draft OIG report notes that LSC does not have an interest in the building at the expiration of the lease. As the OIG knows, the entire transaction surrounding the purchase of 3333 K Street property was structured to conform to OMB and congressional budget rules, and was informally approved by both OMB and the Senate and House Appropriations Committees. If LSC had a direct legal interest in the building upon the expiration of the lease, that arrangement

LSC was involved in every key decision made by Friends: whether to acquire 3333 K Street, how much to bid, and how to finance it.[15] Friends and LSC were attempting to structure a transaction which met the demands of the bank providing the mortgage (which included keeping Friends a viable nonprofit entity), was cost-effective to LSC, met the budgetary and programmatic needs of LSC, and was fiscally responsible to the taxpayers.

In conclusion, the OIG draft report is an incomplete view of this transaction. Even so, had LSC remained at its previous First Street location, per square foot lease costs would exceed what LSC is paying at 3333 K Street beginning this year, with the gap to grow wider each succeeding year for the remainder of the ten year lease and likely beyond.

Moreover, had LSC remained at First Street, the total cost over the ten years would be comparable if not higher (and definitely higher if LSC had leased the additional space its management and Board thought was needed). The draft report also states that the OIG will try to determine if there were benefits to LSC of the move at a later date, although evaluating the benefits would seem to be a necessary element in assessing the wisdom of the transaction entered into by the previous Board and Presidents.

The OIG draft report also implies that Friends of LSC might have slightly overpaid for the K Street building. However, given the value of office real estate in Washington DC today and the development of the surrounding K Street neighborhood since the building was purchased, one might as easily conclude that this purchase was prescient.[16] An article from the March 9,

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would create different and significant issues. However, the charter of Friends requires it to act in the interest of LSC and provides that, should Friends be dissolved, all of its property will be transferred to LSC.

[15] The OIG draft report notes that at the present time neither LSC nor key members of LSC retain control of Friends.

[16] Friends of LSC acquired the building for $14.2 million after a sealed bidding process in which two other parties bid $14 million. The District of Columbia in 2004 assessed the value of the building at $14.8 million for tax purposes. The foresight of the prior LSC Board and senior management is confirmed by the fact that the vacant

2005 issue of *The Daily Record* attests to the strength of the Washington office space market (See Attachment II). It notes that many nonprofits and associations will have to consider leaving the District of Columbia for the suburbs. LSC does not have that option; it is by law required to be located in the District.[17]

The OIG draft report looks back to 2002, uses several highly questionable assumptions, does not take into account all relevant factors, and still fails to prove its contention that LSC made a mistake in leasing 3333 K Street. The Board is mindful that the LSC leasing arrangement, any future leases, and other decisions regarding the occupancy of office space must be fiscally sound and in the best interest of LSC, and the Board fully intends to exercise appropriate oversight. Knowing what we know today, and considering all the factors including LSC's programmatic requirements and the need to be a responsible steward of public funds, this Board cannot conclude that LSC's decision to move to 3333 K Street was either inappropriate or fiscally unsound.

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lot next door when the building was acquired is today an eight story luxury residential building in which the average sale price of condominiums was, according to *The Washington* Post, $1.5 million (*The Washington Post*, March 19, 2005, p. C1). Moreover, Friends of LSC recently received an offer, albeit verbal, of $20 million for 3333 K Street.

[17] Section 1003 of the Legal Services Corporation Act (42 U.S.C. 2996b).

Attachment I

This table compares the per square foot rent of 750 First Street to 3333 K Street. All numbers are from the Blake Report, except that 2012 has been imputed because the Blake Report actually calculated 2002 - 2011. The adjusted rent for K Street credits LSC for the parking subsidy but not for the $2 million build-out, which if adjusted for market terms would reduce the effective rent paid by LSC by another $1-$2 per square foot. The gross amount paid by LSC is $38.00 per square foot in each year.

Year	Estimated Rent Per Square Ft. - 1st Street	Adjusted Rent Per Square Ft. - K Street
2003	36.52	36.96
2004	37.55	36.89
2005	38.61	36.81
2006	39.69	36.73
2007	42.67	36.66
2008	43.82	36.57
2009	45.00	36.49
2010	46.21	36.40
2011	47.44	36.31
2012	48.77	36.23

Attachment II

Wednesday, March 9, 2005 Real Estate, Page 3A

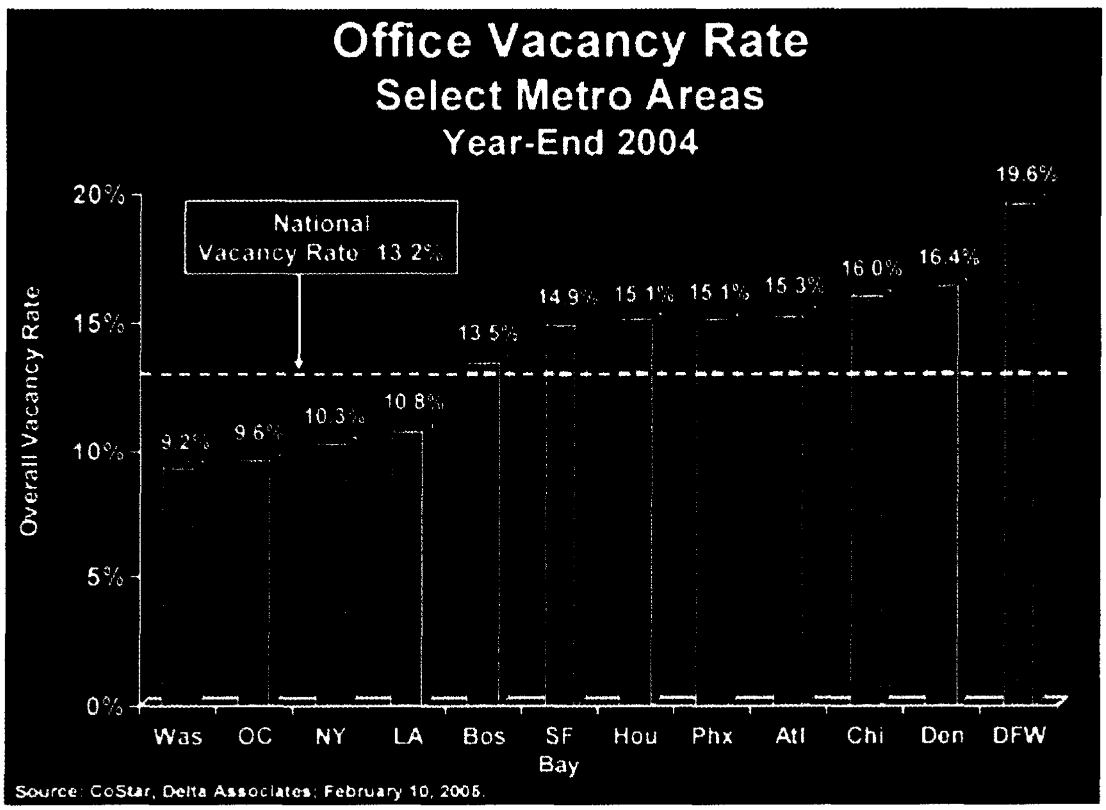
The Daily Record (Baltimore, MD)

Office price hikes on the horizon

By Sofia Kosmetatos
Daily Record Business Writer

A rebounding office market will likely bring rental price spikes in some national markets as early as next year, according to a national market outlook for commercial real estate executives by Delta Associates.

The report by the research arm of Alexandria, Va.-based real estate firm Transwestern Commercial Services recommends developers with permits already in hand move forward with speculative construction about a year to 18 months before the spikes occur "in order to hit the market in stride."



Delta expects rents to spike first in Los Angeles and Orange County, Calif., in 2006, followed by the Washington region in 2007 and 2008. Since last summer, rents have stabilized across the country and have already begun rising in these stronger areas, according to the report.

In the Washington region, parts of Northern Virginia will see spikes first, followed about a year later by parts of suburban Maryland and Washington proper.

Atlanta, Chicago, Houston and Dallas/Fort Worth will be next, seeing rents spike from 2008 to 2009.

Rent growth will vary substantially by market but should be between 3 and 4 percent per year from 2005 to 2007, the report said.

Office market conditions have improved significantly around the country during the past year, evidenced by greater absorption and a steadily declining vacancy rate, the report said.

The Washington region led the country with the lowest vacancy of 9.2 percent at year-end, followed by Orange County at 9.6 percent, New York at 10.3 percent and Los Angeles at 10.8 percent. All four markets were below the 13.2 percent national vacancy rate.

Washington, New York and South Florida will maintain the lowest vacancy rates -- below 9 percent -- during the next expansion, which is expected to last through the end of the decade.

Levels of construction are modest in most markets except for Washington and New York. In Washington, however, much of the new supply is preleased to federal government agencies.

"There's no doubt that every office market in the D.C. area is tightening," said David Houck, senior vice president and manager of The Staubach Co.'s Washington office.

In anticipation of demand, speculative construction has already started in Washington, and Northern Virginia "is raring to go," he said.

But whether there will be rental price spikes in Washington proper is questionable, he said. Rents have risen and will continue to rise in downtown Washington, unlike in parts of the Northern Virginia market that softened after the technology bust.

From the tenants' perspective, any future price hikes will be unsustainable, Houck said.

"More and more firms, particularly...nonprofits and associations, are going to be forced to look at Northern Virginia or suburban Maryland as alternatives to control their costs," he said.

LSC

Legal Services Corporation
Office of Inspector General

Inspector General
Kirt West

May 5, 2005

To the Board of Directors
Legal Services Corporation

Explanation for Omission of Bank of America Appraisal

At the April 30, 2005, closed session of the Board meeting, the Board expressed concern that the OIG had not included the Bank of America appraisal in its lease report. I can appreciate the concern of the Board because it might have appeared that important information had been left out of the OIG report. I assure you that this is not the case. My goal as your Inspector General is to provide you with the most accurate information so that you can carry out your duties. I also want to ensure that any report coming out of the OIG is fair and balanced.

Unfortunately, I did not have any notice that this issue would come up and was therefore not prepared to discuss the specifics of the Bank of America appraisal. I am committed to providing the Board an explanation of why the Bank of America appraisal did not accompany the OIG report. I understand that the Board only became aware of the appraisal shortly before the Board meeting. I wish that I had also been made aware of the Board's concerns so that I could have provided better information to the Board during the meeting. The following explanation should alleviate any concerns that I may have attempted to deceive or intentionally mislead the Board.

I take my responsibilities very seriously and want you to know that upon returning to the office on Monday I immediately began an effort to determine when and how the OIG came into possession of the Bank of America appraisal and whether I had reviewed it. The following is my report to the Board.

Sometime in early January while going through documents provided to the OIG, my staff found what appeared to be the cover page and table of contents of a Bank of America appraisal. However, the actual appraisal was not attached and was not among the other documents provided. As a result, staff had to go to parties outside LSC and eventually obtained a complete copy of the appraisal in mid-January. OIG staff immediately forwarded the document to the two independent commercial real estate appraisers for their consideration. My staff

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determined that it was not material and therefore did not provide me with a copy, did not inform me of its existence and did not include it in the lease report.

I have now personally reviewed the appraisal and can state with certainty that I had never seen it. I have reviewed it in the context of the materials that my staff reviewed in preparing the lease report. Having conducted a thorough personal review, I unequivocally support my staff's decision not to include the Bank of America appraisal in the lease report. The purpose of the report was to provide information to the LSC Board for future decisions with respect to the LSC lease. The OIG appraisers issued their appraisals for the stated purpose of determining whether LSC is paying fair market rent and intended for internal use by LSC management. On the other hand, the stated purpose of the Bank of America appraisal was to aid in the proper underwriting and loan classification for lending purposes and is intended for use by Bank of America, not LSC. Moreover, as indicated by one of OIG's appraisers, the Bank of America appraisal contains limited applicable data and very limited analysis particularly with respect to the rent analysis. Accordingly, the Bank of America appraisal is not material to the OIG's determination of whether LSC is paying fair market rent.

Even though in my judgment it was unnecessary to refer to the Bank of America appraisal, the Board may conclude otherwise. Accordingly, I am issuing some supplemental information to accompany the lease report. The supplemental information will contain an explanation as to why the OIG determined that that the Bank of America appraisal was not material to the OIG lease report and also puts that appraisal in the context of other documents that the OIG had reviewed and also decided not to include in its report. The supplemental information will include a complete color copy of the appraisal and is included with this memorandum that has been sent to all Board members and nominees. Additionally, it will be provided to each Congressional staff member who has either already received the OIG lease report or will be receiving it shortly.

Again, as I state in the supplemental information, the information is being provided to the Board to assist it in executing its fiduciary duties in ensuring the prudent expenditure of Congressionally-appropriated funds. It is up to the Board to decide what action, if any, it might take with respect to the lease report as well as any other information provided by the OIG.

I hope this alleviates any concerns the Board may have had. As always, I am available at any time to discuss this or any other matter with you.

Kirt West

Kirt West
Inspector General

LSC

Legal Services Corporation
Office of Inspector General

Inspector General
Kirt West

May 5, 2005

To the Board of Directors
Legal Services Corporation

Supplemental Information to the April 22, 2005, OIG Report on the Financial Implications of the 3333 K Street Lease

At the April 30, 2005, executive session of the Legal Services Corporation (LSC) Board of Directors meeting, the Board asked the Inspector General why an appraisal commissioned by Bank of America, the mortgagee of 3333 K Street, was not included with the OIG lease report. The Bank of America appraisal was not included because it is not material to the issue of whether LSC is paying fair market rent to its landlord, Friends of Legal Services Corporation (Friends).

The purpose of the OIG lease report was to provide relevant information regarding LSC's lease in order to assist the Board of Directors in exercising its fiduciary duty to ensure that the funds appropriated by the Congress are managed prudently and in accordance with the purpose for which the funds are appropriated. In order to accomplish this, the OIG commissioned two appraisals conducted by independent professional appraisers. Based on the appraisals, the lease report concluded that LSC is paying above market rent.

The stated intended use of the Bank of America appraisal is to aid in proper underwriting and loan classification for lending purposes. The intended user of the appraisal is Bank of America. The purpose of that appraisal is to provide the market value of the property, assuming the existence of the LSC commitment to lease 45,000 square feet at $38 per square foot. On the other hand, the stated intended use of the two OIG commissioned appraisals is to assist LSC management in internal decision making. The intended user of those OIG appraisals is LSC. The purpose of those appraisals is not merely to provide the market value of the property, but *additionally to* determine whether LSC is paying fair market rent for its space at 3333 K Street, at the date of the transaction and assuming an arms-length transaction. [1] Thus, the Bank of America appraisal,

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[1] This is demonstrated by contrasting the detailed analysis of fair market rent contained in the Blake appraisal with the cursory analysis in the Bank of America appraisal.

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unlike the OIG commissioned appraisals, is not material to a determination of whether LSC is paying fair market rent.[2]

Even so, the OIG provided a copy of the Bank of America appraisal to the OIG-commissioned independent appraisers prior to completion of their appraisals. One appraiser indicated that the Bank of America appraisal contained limited applicable data and very limited analysis particularly with respect to the rent analysis. The OIG reviewed many other documents in preparing its lease report, none of which were transmitted with the OIG's lease report. Some of these, however, led to the conclusion that the Bank of America appraisal is not material to the OIG lease report and is in fact useful only for its stated intended use – to assist Bank of America in determining whether to loan Friends the funds to purchase 3333 K Street. The following two documents exemplify this:

- Grubb & Ellis, the listing agent for the seller of 3333 K Street, prepared a Confidential Offering Memorandum. This memorandum indicates that it would likely take until 2010 before the market rental rates for the building would reach LSC's rate of $38.00 per square foot. The listing agent's conclusion is consistent with the OIG's calculations in its lease report.

- Dawn Carpenter of EOS Financial, Friend's outside consultant, prepared an April 14, 2003, memorandum on the LSC lease to address concerns raised by the OIG. The memorandum states that Bank of America mandated the lease rate of $38.00 per square foot. The memorandum supports its conclusion by reference to the Studley Report and an analysis by CB Richard Ellis. The memorandum states that Friends relied on the Studley Report to support LSC's rent of $38.00; the Studley Report shows the average offered rental rate in Georgetown for Class A space at the time to be $40.80 per square foot.[3] The memorandum further states that Friends relied on a CB Richard Ellis analysis that the

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[2] The Bank of America appraisal took into account the LSC lease and thus cannot provide a basis for concluding on the issue of fair market rent. Prior to agreeing to make a loan to Friends, Bank of America required that Friends obtain LSC's commitment to lease 45,000 square feet for $38.00 per square foot for 10 years. Further, the Bank of America appraisal was based on the purchaser entering into a non-arms length rental rate and occupying all of the vacant space. LSC President and Board member John Erlenborn at one time was serving concurrently as Friends' President and Board member. In October 2001, Mr, Erlenborn recognized the difficulty of a non-arms length transaction and the need for LSC and Friends to enter into contract negotiations. Consequently, he submitted a letter of resignation to the Friends Board stating that his simultaneous service to LSC and Friends created the appearance and possibly the reality of a conflict of interest. Moreover, Mr. Erlenborn was concerned that Friends was discussing the possibility of purchasing a building without conferring with the Bush White House and OMB, instead relying on conversations with the Clinton administration.

[3] The Studley Report lists only 15,033 square feet of Class A available space and 201,571 square feet of non-Class A available space. These were offered rents, which may not be the actual rents that are paid once the parties enter into a lease agreement.

average Class A market rent in Georgetown was $38.50. However, 3333 K Street is not a Class A building and according to the Studley Report, the average non-Class A space in Georgetown at that time was offered at $32.39. It is noteworthy that even Ms. Carpenter's memorandum, the purpose of which was to support Friends' charging LSC $38 per square foot, does not mention the Bank of America appraisal.

As mentioned, the OIG provided the Bank of America appraisal to its two independent appraisers for their consideration. The independent appraisers nonetheless concluded that LSC agreed to pay above market rent in July 2002 and continued to pay above market rent as of November 2004. The independent appraisers reviewed the leases that Friends has entered into with non-LSC tenants since July 2002 when LSC signed its lease with Friends. In all instances, the rent paid by the non-LSC tenants is below market thereby at least creating the appearance that LSC's above market rent is subsidizing the rent of the non-LSC tenants. The appraisers' conclusions also are supported by Friends submission to the D.C. Board of Real Property Assessments for 2003 in which Friends states that a market rent of $28.00 per square foot for that calendar year is appropriate for the building. This is consistent with the $28 range for 2003 that the OIG calculated using the independent appraisals.

The information here provided is intended as a supplement to information previously provided to the Board in the OIG lease report. That report, for example, informed the Board that should LSC enter into a lease extension for another ten years under existing terms it would take several years beyond 2013 before LSC recoups the overpayment on the original lease; a proposed lease extension by Friends would have LSC pay pass through costs that could reduce or even eliminate any future savings; a signed July 20, 2004 MOU between Friends and LSC, in which LSC would pay rent under the Building Owners & Managers Association (BOMA) method of measurement and pay for pass through costs, could increase LSC's annual rent rate to more than $43.00 per square foot or by more than $200,000 per year without even factoring in the potential payment of pass through costs.[4]

The Bank of America appraisal was intended to support the loan made by Bank of America to Friends, LSC's landlord. The OIG lease report, on the other hand, is intended to provide the LSC Board with information relevant to its decision-making regarding LSC's occupancy of 3333 K Street. In conclusion, the Bank of

[4] At an April 2004 Friends Board meeting, it was reported that 42,852 square feet that LSC was occupying at the time would be equivalent to 48,800 under the BOMA standards.

America appraisal was not included with the OIG lease report because it is not material to the issue of whether LSC is paying fair market rent to its landlord. The appraisal is attached, however, for informational purposes.

Kirt West

Kirt West
Inspector General

Enclosure: Bank of America Appraisal

RESPONSE
OF THE
LEGAL SERVICES CORPORATION
TO THE
SUPPLEMENTAL INFORMATION TO THE APRIL 22, 2005, OIG REPORT ON THE FINANCIAL IMPLICATIONS OF THE 3333 K STREET LEASE

On April 22, 2005, the Office of the Inspector General (OIG) of the Legal Services Corporation released a "Report on the Financial Implications of The 3333 K Street Lease." The report was accompanied by a detailed response from the Board of Directors of the Corporation which rejected much of the analysis and many of the conclusions reached by the OIG, and noted that "this Board cannot conclude that LSC's decision to move to 3333 K Street was either inappropriate or fiscally unsound." That report, which is attached, provides additional information with respect to the transaction.

On April 27, 2005, LSC received a copy of an appraisal commissioned by Bank of America and undertaken in May, 2002 by the firm Chaney & Associates. The appraisal was commissioned by Bank of America to help determine whether it should make a loan to Friends of Legal Services Corporation ("Friends") for the purchase of the 3333 K Street building to be used as LSC headquarters. The appraisal concluded that the price proposed to be paid by Friends was reasonable and that the estimated rent to be paid by LSC "is within the range of the comparables," conclusions completely at odds with the two retrospective appraisals commissioned by the OIG.[1] The OIG obtained this conflicting appraisal by mid-January but chose not to reveal its existence to either the Board or LSC Management, even though OIG staff was aware of the Board's concerns about the OIG report weeks before its release. The LSC Board questioned the Inspector General about this matter in an executive session on April 30, 2005.

On May 5, 2005, the Inspector General of the Legal Services Corporation released "Supplemental Information" to the OIG April 22 report. The apparent purpose of this "Supplemental Information," which was provided to Congress before it was provided to the LSC Board and without giving the Board a chance to respond, is to justify the OIG's withholding of critical information from the Board. The Inspector General does so by asserting that the Chaney appraisal is not material because it was intended for use by the Bank of America and it failed to properly analyze what a fair market rent for LSC would be. The first argument is unconvincing and the second appears incorrect.

[1] As is noted in the appraisal by Joseph J. Blake & Associates, "a retrospective value estimate is most frequently utilized in connection with appraisals for state tax, condemnation, inheritance and similar purposes." LSC objected in its response to the OIG Report to a number of the assumptions in the retrospective appraisals, a position now validated by the Chaney appraisal.

1. The Chaney appraisal appears more credible, not less, than those commissioned by the OIG.

The Chaney appraisal was commissioned by the Bank of America in 2002 for the purpose of assisting the Bank in determining whether it should provide a loan to Friends to finance the purchase of 3333 K Street. Friends was a newly created non-profit corporation with no operating history. Bank of America, in order to justify the loan, had to satisfy itself that the purchase price was reasonable and that the rent being paid by the anchor tenant, LSC, was reasonable.[2]

In short, real money was on the line. The appraisal, rather than being invalid or immaterial because Bank of America paid for it and was the intended user, would appear to be more valid and more reliable than the appraisals commissioned by the OIG in 2005.

In contrast to the Chaney appraisal, the appraisals commissioned by the OIG in 2005 were retrospective, did not take into account the 2003-2013 term of the lease but focused purely on July 2002, eleven months before LSC moved into the building. It also failed to correctly factor in tenant improvements made to the building at the landlord's expense and contained numerous other questionable assumptions.

At the April 30 executive session of the Board, it was suggested to the Inspector General that his Office review the Chaney appraisal and explain the differences between it and the two appraisals the OIG paid for. The Inspector General has chosen not to do so. Accordingly, LSC staff has prepared Attachment A which lists some of the major differences in assumptions between the Chaney appraisal and the Blake appraisal[3] commissioned by the OIG. The Board now concludes that the Chaney appraisal appears to be based on more realistic and appropriate assumptions and, accordingly, that its conclusions on fair market rent are more likely correct than those made by the OIG using the OIG-commissioned appraisals.

2. The "Supplemental Information" incorrectly describes the Chaney appraisal's calculation of fair market rent.

The Inspector General simply asserts that the Chaney appraisal "is not material to a determination of whether LSC is paying fair market rent."[4] The only evidence to support that assertion is that "[o]ne appraiser indicated that the Bank of America appraisals contained limited applicable data and very limited analysis particularly with respect to the rent analysis."[5]

In fact, the Chaney appraisal used four rental transactions which had closed earlier in 2002 and a fifth pending on the market at that time. Based on the terms, and factoring in an above market $40 per square foot build-out allowance, Chaney concluded that a fair market

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[2] LSC could and can terminate the lease for lack of a sufficient appropriation. Therefore, the Bank had to consider scenarios where LSC would not be the building's anchor tenant.

[3] As in the LSC response to the OIG report, LSC is again using the Blake appraisal for comparative purposes because the Blake appraisal is more explicit about its assumptions and methodology, making comparisons easier.

[4] Supplemental Information, p. 2.

[5] Ibid, p. 2.

rental for the 3333 K Street space would be $36.25 per square foot for a 10 year lease, with a 2.5 percent annual increase and a $2.50 bump in the 6th year. Chaney then concluded the proposed $38.00 per square foot is "within the range of the comparables."[6] The $38.00 per square foot rent proposed to be paid by LSC included no annual increases, no 6th year bump, and no building cost pass-throughs. The Inspector General may choose to disagree with the Chaney estimate, but it was and remains a legitimate estimate.

By contrast, the OIG calculations, using the Blake appraisal to estimate LSC's alleged fair market rent, incorporated a number of highly questionable assumptions. First, as explained in detail in the earlier LSC response, the OIG calculations are based on an assumption that LSC received $15 per square foot in tenant improvement concessions rather than up to $44 per square foot as provided for in the lease agreement. That inaccurate build-out figure accounts for nearly 70 percent of the LSC's alleged overpayment.

The OIG calculations are based on comparables, 11 of 17 of which date from 2001, rather than 2002 when the building was acquired or 2003 when LSC began paying rent. Six of the comparables are transaction under 3,500 square feet, and another 6 were transactions under 11,000 square feet. This is an inappropriate comparison to the 45,000 square feet being rented LSC. Worse still, three of the comparable transactions were leases that the Blake appraisal itself said were below market rates. In addition, the Blake appraisal undervalued the parking subsidy LSC receives from the landlord.

Conclusion

The Supplemental Information provided by the Inspector General glosses over or ignores the substantive differences between the appraisals. Instead, he asserts the OIG-commissioned appraisals are better than the one commissioned by Bank of America because the OIG-commissioned ones were for the OIG while Bank of America's was for the Bank. He then states that one unnamed appraiser found the Bank-commissioned appraisal to contain limited data and limited analysis, with no further explanation or detail. In effect, the Inspector General asserts he was correct in withholding critical information from the LSC Board and Congress but fails to state why.

The Board is not persuaded. The contemporaneous appraisal undertaken by Chaney & Associates supports the position of the Board in its original response to the OIG report. The OIG was aware of the Board's views over four weeks before the OIG report and the LSC response were released to Congress, and the Inspector General now asserts it was acceptable for him to withhold information supporting the Board's position from the Board because the OIG had determined "it was not material."

The only analysis of the transaction undertaken by a party independent of LSC or the OIG supports the rent being paid by LSC as being within fair market value. That is not only material, but it confirms the judgment previously made by the Board and further discredits the OIG's April 22 report.

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[6] Chaney appraisal, p. 34.

MAJOR DIFFERENCES IN ASSUMPTIONS BETWEEN THE BLAKE RETROSPECTIVE APPRAISAL (COMMISSIONED BY THE OIG) AND THE CHANEY APPRAISAL (COMMISSIONED BY BANK OF AMERICA)

Assumption/Fact	Chaney	Blake
Date Issued	May 29, 2002	January 25, 2005
Date of Evaluation	May 21, 2002	July 1, 2002[1]
Purpose of the appraisal	Provide market value "as is" and prospective market value upon completion of renovation "as an aid in proper underwriting and loan classification for lending purposes … by Bank of America."	Provide market value under 2 scenarios: "as is" defined as 46% occupied (July 2002 occupancy rate) and "as if stabilized" (95% occupancy - "to aid LSC in internal decision making."
Outlook for Georgetown market	Neighborhood is in a "growth stage" … "ongoing development" … "outlook for area is considered positive" … "office conditions will likely remain stable in the near term with potential undersupply possible if the local" economic recovery continues (Chaney, pp. 14-16)	"Georgetown office market has shown signs of weakening over the last 12 months … we expect the subject market to equalize in the near term." (Blake, p. 46)[2]
Comparable rents - 3333 K Street location	Noted the ongoing and planned development surrounding 3333 K Street. Treated it as part of Georgetown waterfront business district.	"Subject's location is considered to be a fringe location in Georgetown submarket." (Blake, p. 30). No mention of surrounding development (some of which has since occurred). Blake then adjusted all comparable rents downward to offset their "superior" location.
Comparable rents - size of property	Three of 5 comparables were large transactions like LSC's with Friends (45,000 SF). No transaction was under 12,000 SF.	Only 2 of 17 comps were large transactions. Six comps were under 3,500 SF and 6 more were between 5,500 and 11,000 SF. Two comps were about 18,000 SF and one was about 22,000 SF.

[1] Blake stated, "A retrospective value estimate is most frequently utilized in connection with appraisals for state tax, condemnation, inheritance tax and similar purposes." (Blake, p. 15)

[2] The actual facts since 2002 are closer to Chaney's projection then to Blake's retrospective analysis.

Assumption/Fact	Chaney	Blake
Comparable rents - time	All comparables were from 2002.	11 of 17 comps were from 2001.
Comparable rents - 3333 K Street	Concluded that all 3333 K St. leases were below market value, so they weren't used in the comps.	Concluded that all 3333 K St. leases were below market value, but used 3 for the fair market valuation.
Fair market rental calculation - TI package	Assumes $40/SF tenant improvement allowance.	Assumes only $15/SF in setting fair market rent, even while noting that LSC tenant improvement package was $44/SF.
Fair market rent (1^{st} year, full service terms)[3]	$35.38/SF assuming no parking subsidy, and $36.25/SF assuming free parking.	$26.42/SF[4]
Parking	Values parking at $175/month per spot based on survey of neighboring garages.	Values parking spaces at $150/month based on rate 3333 K was then charging. Blake did a survey of neighboring garages with a result similar to Chaney, but discounted it for unstated reasons.
Equivalent 1^{st} year payment by LSC, if 3333 K lease converted to standard full service lease	No specific calculation, but concluded LSC terms were "within the range of the comparables."	$32.15/SF, but mistakenly assumes no above-market tenant improvement package; also, as noted, sets fair market parking at $150/month.

[3] Blake's fair market rent estimate is for July 2002. It is not clear what date Chaney's estimate is for, although Chaney knew LSC would not be moving into the building until 2003. LSC did not commence paying rent until June 2003.

[4] Of the $8.96/SF difference in initial fair market value, from $3.75 to $5.00/SF, depending on the discount rate chosen, can be accounted for simply on the basis of the differing tenant improvement assumptions, i.e., Chaney's $40/SF versus Blake's $15/SF. Thus if Blake's estimate were adjusted to $40/SF, his initial fair market rent would be $30.17-$31.42. This single adjustment eliminates most of the difference between Blake's fair market rent calculation and Blake's $32.15 estimate of LSC's rent when converted to standard terms (see below). The result is also similar to the cash analysis contained in the LSC response to the OIG report, which concluded that nearly 70 percent of the amount that allegedly was paid in above market lease payments disappeared when the tenant improvement package is correctly accounted for.

LSC

Legal Services Corporation
Office of Inspector General

Inspector General
Kirt West

MEMORANDUM

TO: Board of Directors

FROM: Kirt West Kirt West
Inspector General

DATE: June 13, 2005

SUBJ: OIG Lease Report

By letter dated May 26, 2005, the Board addressed to Congress a response to my May 5, 2005 memorandum to the Board, in which I provided supplemental information to the OIG's lease report. For some reason, I did not receive a copy of the Board's response until June 9. In addition, I continue to be perplexed about the Board's responses and am sincerely concerned about possible miscommunications. The Board's response contains a serious allegation against me, and I am providing this response not only to address the allegations against me but also in the hopes of clarifying any miscommunication.

The Board's response and its accompanying cover letter to the Congress states that the OIG "withheld" the Bank of America commissioned appraisal from the Board and "chose not to reveal its existence," and that in doing so the IG "with[held]" critical information from the LSC Board and Congress."

I DID NOT PERSONALLY WITHHOLD INFORMATION

First, I did not know about the report or any decision not to disclose it. By memorandum dated May 5, 2005 (accompanying the supplemental information and attached hereto), I provided the Board with an account of how and when the OIG came into possession of the appraisal and how it was put to use. As stated in that memorandum: "I have now personally reviewed the appraisal and can state with certainty that I had never seen it." It is simply not possible for me personally to have "withheld" from either the Board or Congress that which I had never even seen.

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THE OIG STAFF DID NOT DECIDE TO WITHHOLD INFORMATION

Second, my staff knew about the report and it was provided to the appraisers for their information. My staff did not discuss with me or among themselves whether or not to include the Bank of America appraisal to the Board and no one in the OIG ever decided to withhold information from the Board. After the Board raised this concern, I spoke to my staff. As the May 5th memorandum and the supplemental information clearly establish, the appraisal was not material to the OIG's determination of whether LSC is paying fair market rent, and I therefore support my staff not including it with the two OIG appraisals.

LSC MANAGEMENT HAD IN ITS POSSESSION THE BANK OF AMERICA APPRAISAL BEFORE THE OIG RECEIVED THE APPRAISAL

Third, to the best of my knowledge, LSC management had a copy of the Bank of America appraisal before the OIG obtained a copy. In mid-May 2005, one of my staff brought to my attention that among the many documents provided to the OIG by LSC management was a copy of the Bank of America appraisal date stamped June 14, 2002.[1] Thus, it appears LSC management was aware that it had the appraisal at the time the Board prepared its response to the OIG draft report and could have brought it to the attention of the Board or the OIG before issuance of the final report.

Although I can understand you are displeased that you did not know about the Bank of America appraisal, I can you assure that the information the OIG has provided to the Board is based on hard, objective evidence, not opinion or subjective judgment. I would ask that you consider the following which I believe will explain why the Bank of America appraisal is not helpful in supporting the amount of rent LSC is paying to Friends.

THE BANK OF AMERICA APPRAISAL IS NOT HELPFUL IN DETERMINING FAIR MARKET RENT BECAUSE IT USED CLASS A RENTS TO DETERMINE FAIR MARKET RENT FOR A CLASS B BUILDING

Because 3333 K Street is a Class B building, the OIG's two independent appraisers looked at comparable Class B buildings specifically to determine fair market rental rates. This was an important and critical element of the appraisal because in 2002 Class A rentals in Georgetown were approximately $8 per square foot higher than Class B rentals. The Bank of America appraisal, however, failed to distinguish between Class A and Class B properties. By not distinguishing between classes of buildings (in fact, the Bank of America appraisal did not even mention that 3333 K Street was a Class B

[1] The OIG has determined that the date stamped appraisal did not come from the documents that the OIG received from Friends. Because of the large volume of documents received from both Friends and LSC, the OIG is not sure exactly when it became of aware of the date stamped copy except that it occurred at some time after the OIG received the appraisal from Bank of America.

building), the Bank of America appraisal overstated the rents for 3333 K Street by using Class A comparables.

THE BANK OF AMERICA COMPARABLES WERE NOT ACTUALLY COMPARABLES

Two of the five Bank of America comparables were Class A space: the Watergate Office Building (Comparable #3) which is not even located in Georgetown and Washington Harbor (Comparable #4), which is one of the most desirable office buildings in Washington, D.C. Moreover, a third comparable, the Foundry Building (Comparable #2), is probably the second most desirable office space in Georgetown (Two major law firms Foley & Lardner and Swidler Berlin, renting space at Washington Harbor, leased space at the Foundry Building when they needed to expand but there was no available space at Washington Harbor.). Inexplicably, the Bank of America appraisal downgraded the Foundry Building in its fair market rent analysis, which only reinforces the notion that the appraisal was for a purpose other than determining what fair market rent LSC should pay. A fourth comparable (Comparable # #5) was listed as available for rent with no existing lease and therefore is in fact not a comparable and should not have been considered. Thus, the Bank of America appraisal is left with one legitimate comparable (#1) which demonstrates the lack of materiality.

In my supplemental information, I stated that one of the appraisers stated that the Bank of America contained limited applicable data and very limited analysis particularly with respect to the fair market rent analysis. Specifically, it contained no analysis of the relative merits of the comparables nor did it provide any justification for the adjustments in comparables in determining fair market rent. The Blake appraisal, on the other hand, contains a detailed discussion of Class B rents. The Blake appraisal also contains an analysis of each comparable as well as each lease within the comparable building and provides a rationale for adjustments. Again, this simply demonstrates that the purpose of the Bank of America appraisal, unlike the OIG-commissioned appraisals, was not to determine the fair market rent for LSC.[2]

[2] The appraisal in question was commissioned by the lender. Consideration of the party that commissioned the appraisal is important to any assessment of the appraisal's usefulness by another party and/or for another purpose. For example, lenders are not permitted to use appraisals commissioned by the borrower in support of a loan transaction and may only use appraisals commissioned by loan brokers or other lenders if certain strict criteria are met. *See* Interagency Statement on Independent Appraisal and Evaluation Functions (issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration), 10/28/03.

SUBSTANTIAL EVIDENCE SUPPORTS THE CONCLUSION THAT LSC IS OVERPAYING RENT AT 3333 K STREET

Additional evidence supports the analysis of OIG's two independent appraisers. For example:

- In the fall of 2001, Grubb & Ellis, the listing agent for the seller of 3333 K Street indicated in a Confidential Offering Memorandum that it would likely be 2010 before the building would achieve a $38 per square foot rate. The OIG lease report stated that LSC would be paying above market rent until 2010.

- Friends' submission to D.C. Board of Real Property Assessment states that a market rent of $28.00 per square foot for calendar year 2003 is appropriate. This is consistent with the OIG's calculations for 2003 based on the information provided by the two independent appraisers.

- An April 1, 2004, email from Friends Board Member Jack Martin to LSC Senior Assistant General Counsel and Friend's staff member Lynn Bulan, and Friends Board members Thomas Smegal, Alex Forger, Hulett Askew, Victor Fortuno (also LSC General Counsel) and David Richardson (also LSC Comptroller) states in pertinent part: "CB Richard Ellis tells us that the rental rate for the first floor LSC space would likely fall in the $24-26 range with 2.5% to 3.0% escalations. There will likely be 4-6 months downtime to find a user and we'll have to provide the tenant with paint and carpet to build out space pursuant to Julie's most recent layout suggestion. The rental rate for the fourth floor would likely be in the mid-30s plus escalations and passthroughs as the vacant space [LSC's Office of Government Relations and Public Affairs now occupies that space] has good river views." *[Note: On March 23, 2004, eight days earlier, Friends had entered into a lease for the non-river view side of the fourth floor with Victor Properties, LLC/Penzance Management at $30.45 per square foot with an effective rent of $28.55 per square foot considering concessions.]* The information provided by CB Richard Ellis to Friends is actually below Blake's November 2004 market rent projection of $29.00 per square foot for the first floor.

- All six leases that Friends has negotiated with non-LSC tenants since July 2002 are at a below market rate.

These four points are just part of the overwhelming weight of the evidence demonstrating that LSC's rental rate of $38.00 per square foot is above market. The only evidence to the contrary would be the Bank of America appraisal which, as clearly demonstrated, rests on a very shaky foundation.

I hope this response leaves no doubt that neither I nor my staff withheld any information from the Board or the Congress. In addition, I hope that the Board can now more fully appreciate why the Bank of America appraisal does not bear on the question of whether LSC is paying fair market rent for its space.