City of New York

OFFICE OF THE COMPTROLLER

Scott M. Stringer
COMPTROLLER

FINANCIAL AUDIT

Marjorie Landa

Deputy Comptroller for Audit

Audit Report on Sunstone Hotel Investors, Inc.'s Compliance with Its Lease Agreement to Operate the Hilton Times Square Hotel

FK13-088A

January 28, 2015

http://comptroller.nyc.gov

THE CITY OF NEW YORK
OFFICE OF THE COMPTROLLER
1 CENTRE STREET
NEW YORK, NY 10007

SCOTT M. STRINGER
COMPTROLLER

January 28, 2015

To the Residents of the City of New York:

My office has audited Sunstone Hotel Investors, Inc. (Sunstone) to determine Sunstone's compliance with its lease agreement to operate the Hilton Times Square Hotel. We audit entities such as Sunstone to ensure that they accurately and completely report revenues, properly calculate and pay rent to the City, submit their rent payments on time, and comply with other significant lease terms.

The Hilton Times Square Hotel was built by FC 42 Hotel, LLC and sold to Sunstone in March 2006. The New York City Economic Development Corporation (EDC) administers the lease on behalf of the City and is responsible for ensuring Sunstone complies with lease terms, including the payment of all rents due the City.

The audit found that Sunstone did not properly calculate the Formula Percentage Rent and did not comply with certain significant lease terms. Specifically, Sunstone did not make Furniture, Fixtures, and Equipment (FF&E) contributions, did not use FF&E funds for their intended purposes, and did not submit to EDC required financial and operating reports in the manner and time frames specified by the lease agreement. The audit also found that EDC did not adequately monitor Sunstone to ensure its compliance with lease terms.

The audit recommends that Sunstone properly calculate the Formula Percentage Rent; replenish $4,424,615 to the FF&E reserve account ($3,093,862 for contributions that were not made or maintained, $908,721 for interest, and $422,032 for improper disbursements); make and maintain FF&E contributions; use FF&E reserve account funds only for FF&E qualifying expenses; maintain documentation evidencing how FF&E funds are used; and submit to EDC required financial and operating reports in the manner and time frames specified by the lease agreement. The audit also recommends that EDC ensure that Sunstone replenishes $4,424,615 to the FF&E reserve account and complies with other report recommendations; and that it routinely demand and review the monthly and annual reports submitted by Sunstone to ensure the accuracy of the calculation of the Formula Percentage Rent.

The results of the audit have been discussed with Sunstone and EDC officials, and their comments have been considered in preparing this report. Their written responses are attached to this report.

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

Sincerely,

Scott M. Stringer

TABLE OF CONTENTS

THE CITY OF NEW YORK
OFFICE OF THE COMPTROLLER
FINANCIAL AUDIT

Audit Report on Sunstone Hotel Investors, Inc.'s Compliance with Its Lease Agreement to Operate the Hilton Times Square Hotel

FK13-088A

EXECUTIVE SUMMARY

The New York City Economic Development Corporation (EDC) administers the lease (the Lease) for the Hilton Times Square Hotel (the Hilton), located at 234 West 42nd Street. The Hilton was built by FC 42 Hotel, LLC, and sold to Sunstone Hotel Investors, Inc. (Sunstone), in March 2006. EDC is responsible for ensuring Sunstone complies with Lease terms, including the payment of all rents due the City.

In accordance with terms defined in the Lease, Sunstone must pay a "Base Rent" and an additional "Percentage Rent." For the period April 1, 2006, through April 30, 2020, the Percentage Rent is to be calculated by determining the greater of either the minimum amount specified in the Lease or, alternatively, a "Formula Percentage Rent"[1] based on the "Adjusted Gross Revenues (AGR)"[2] and the "Adjusted Total Hotel Project Cost (ATHPC)."[3] For the period May 1, 2020, through December 12, 2095, Percentage Rent will be based only on the above-described Formula Percentage Rent; the minimum amount specified in the Lease will no longer be applicable. For Calendar Year 2012, Sunstone paid the City rent of $1,772,194, consisting of the Base Rent of $683,032 and the specified minimum Percentage Rent of $1,089,162. (See Appendix I Sunstone Reported Occupancy, Revenues, and Expenses, and Rents Paid, Calendar Year 2008 through Calendar Year 2012.)

---

[1] "Formula Percentage Rent" is calculated as follows: 12% [(The < of: AGR or 14% ATHPC) – 12% ATHPC] + 18% (AGR – 14% ATHPC).

[2] "Adjusted Gross Revenues" is defined in Article 1, Section 1.01 of the Lease as "for any Lease Year (or calendar quarter, as the case may be), Gross Revenues for such period less Operating Expenses for such period."

[3] "Adjusted Total Hotel Project Cost" is defined in Article 1, Section 1.01 of the Lease as "Initial Total Hotel Project Cost as increased by fifty percent (50%) of the amount by which the gross consideration received by Tenant in connection with the first Third-Party Sale exceeds Initial Total Hotel Project Cost."

In addition to rent, Sunstone must also annually contribute the greater of either 3 percent of "Gross Revenues"[4] for such Lease Year or the amount required by the Recognized Mortgagee then most senior in lien to be contributed to the FF&E Replacement Reserve for each such Lease Year to a segregated reserve account for the replacement or refurbishing of "Furniture, Fixtures, and Equipment (FF&E)," pay "Impositions" as defined in the lease,[5] and maintain specified types and amounts of insurance coverage. To ensure compliance with these and other lease provisions, the Lease requires Sunstone to submit to the City financial and operating reports and certified copies of insurance policies.

Audit Findings and Conclusions

The audit found that Sunstone generally maintained adequate controls over its revenue recording and reporting processes and paid the Base Rent due the City in a timely manner.

However, our review also found that Sunstone improperly calculated the Formula Percentage Rent in two ways. First, Sunstone appears to have overstated ATHPC by as much as $19.8 million and second, it understated AGR by $1 million. The result of these two errors has been an understatement of the Percentage Rent due the City which could result in future repeated underpayments to the City up through and including the Lease end date of December 12, 2095. (See Appendix II Comparative 2011 ATHPC and Formula Percentage Rent Calculations.) Because the minimum Percentage Rent specified in the Lease for the scope period has been greater than the alternative Formula Percentage Rent properly calculated, our adjustments did not result in additional Percentage Rents due the City. However, by reporting the correct lower amount of ATHPC, the Formula Percentage Rent could become due sooner and in greater amounts, which would increase the total amount of money Sunstone would be obligated to pay to the City under the Lease.

The audit also found that Sunstone miscalculated the Percentage Rent based on a misinterpretation of the Formula Percentage Rent. This miscalculation did not result in an understatement of Percentage Rent due the City. Rather, the proper application of the Formula Percentage Rent may result in lower Percentage Rent payments being due. (See Appendix III Comparative 2011 Formula Percentage Rent Methodologies and Calculations.)

Additionally, the audit found that Sunstone did not make or maintain required FF&E reserve contributions totaling $3.1 million and improperly disbursed FF&E funds totaling $7.3 million. Sunstone also did not submit to ESDC and EDC required financial and operating reports, rendering them unable to effectively assess, monitor, and hold Sunstone accountable for its performance.

Finally, in connection with our audit of Sunstone, we observed that EDC did not adequately monitor Sunstone to ensure its compliance with Lease terms.

[4] "Gross Revenues" is defined in Article 1, Section 1.01 of the Lease as "all revenues, receipts, and income of whatever kind and nature, of Tenant and Manager, and of any Subtenant that is a Related Entity of Tenant or Manager, as determined in accordance with Accounting Principles, in any Lease Year (or calendar quarter, as the case may be)," with minor exceptions, "generated from the operation, leasing or management of the Hotel Project."

[5] "Impositions" are defined in Article 1, Section 1.01 of the Lease as "all taxes, fees, assessments, and charges that are levied by a governmental agency," Business Improvement District (BID) "or similar entity against the Property and New 42 Hotel Property or the interest of Tenant therein," such as special assessments, sales, use and occupancy, and water and sewer charges.

Audit Recommendations

To address these issues, we make 14 recommendations—8 to Sunstone and 6 to EDC—including that Sunstone should:

- Properly calculate the Formula Percentage Rent.
- Replenish $4,424,615 to the FF&E reserve account ($3,093,862 for contributions that were not made or maintained, $908,721 for interest, and $422,032 for improper disbursements).
- Make and maintain FF&E contributions as required by the Lease.
- Use FF&E reserve account funds only for FF&E qualifying expenses as stipulated by the Lease.
- Maintain documentation evidencing how FF&E funds are used as required by the Lease.
- Submit to EDC, in the manner and time frames specified by the Lease, required financial and operating reports including but not limited to: annual audited property-level financial statements; monthly STR reports comparing Hilton's performance to that of the Competitive Set regarding occupancy, average room rate, and other data; property inspection reports; and certified FF&E reserve account depository statements, and budgeted and actual utilization reports with explanations of variances.

With regard to Sunstone, EDC should:

- Ensure that Sunstone properly calculates the Formula Percentage Rent in accordance with the Lease.
- Routinely demand and review the monthly and annual reports submitted by Sunstone to ensure the accuracy of the calculation of the Formula Percentage Rent.
- Ensure that Sunstone replenishes $4,424,615 to the FF&E reserve account.
- Ensure that Sunstone submits to EDC, in the manner and time frames specified by the Lease, required financial and operating reports including but not limited to: annual audited property-level financial statements; monthly STR reports comparing Hilton's performance to that of the Competitive Set regarding occupancy, average room rate, and other data; property inspection reports; and certified FF&E reserve account depository statements, and budgeted and actual utilizations reports with explanations of variances.

Sunstone and EDC Responses

In their responses, both Sunstone and EDC maintained that when calculating Percentage Rent, ATHPC was not overstated and asserted that the Initial Total Hotel Project Cost (ITHPC) should be $113.3 million based, in large part, on a sample development budget included in the Lease.

Sunstone also asserted that it does not owe any money to the FF&E reserve account and moreover, that Sunstone had overfunded this account. EDC agreed "that maintaining a FF&E account is appropriate" and indicated that it will "ensure that the proper amount is funded and maintained in the future." However, EDC did not agree to ensure that Sunstone replenishes $4,424,615 to the FF&E reserve account.

With regard to the report's remaining findings, both Sunstone and EDC indicated that they already did or will in the future implement the report's recommendations.

As the Lease administrator, EDC has a responsibility to ensure that Sunstone fulfills its Obligations, properly calculates Percentage Rent, and makes all Lease-required payments. Since Percentage Rents are based, in part, on ITHPC throughout the life of the 97-year Lease ending December 12, 2095, EDC should ensure Lease compliance by determining the proper value of ITHPC as expressly required by the Lease rather than rely on a sample budget.

Additionally, Sunstone does in fact owe $4,424,615 to the FF&E reserve account. Sunstone's assertion that it overfunded the FF&E reserve account is based largely on a $3,450,000 contribution that Sunstone claimed that it made in 2010. However, these funds were not deposited in and do not relate to Sunstone's Lease-required FF&E Replacement Reserve account. If Sunstone does not immediately replenish the FF&E reserve account, EDC should send Sunstone a written notice demanding that it replenish $4,424,615 to the FF&E reserve account within 30 days and pursue all remedies available to it under the Lease if Sunstone does not comply.

Sunstone's and EDC's responses and our rebuttals are discussed in greater detail in this report.

AUDIT REPORT

Background

EDC, pursuant to a contract with the City of New York (the City), administers the Lease[6] for the Hilton located at 234 West 42nd Street. The Hilton was built by FC 42 Hotel, LLC, pursuant to the Lease and sold to Sunstone in March 2006. Under the Lease, the State of New York was the holder of an estate on limitation and the City was a holder of a reversionary interest in the "Property."[7] EDC fully assumed the Lease administration effective July 2011 and the Property reverted to the City in October 2012. Pursuant to its contract with the City, EDC is responsible for ensuring Sunstone complies with Lease terms, including the payment of all rents due the City.

In accordance with terms defined in the Lease, Sunstone must pay a Base Rent and a Percentage Rent. For the period April 1, 2006 through April 30, 2020, the Percentage Rent is calculated by determining the greater of the minimum amount specified in the Lease or, alternatively, a Formula Percentage Rent based on AGR and ATHPC. The ATHPC is based on the "Initial Total Hotel Project Cost (ITHPC)"[8] and the gross consideration received for the sale of the Hilton in 2006. For the period May 1, 2020, through December 12, 2095, Percentage Rent will be based only on the above-described Formula Percentage Rent and the minimum amount specified in the Lease will no longer be applicable. In addition to the rent, Sunstone must also annually contribute either the greater of 3 percent of Gross Revenues for such Lease Year or the amount required by the Recognized Mortgagee then most senior in lien to be contributed to the FF&E Replacement Reserve for each such Lease Year to a segregated reserve account for the replacement or refurbishing of FF&E, pay Hilton Impositions and maintain specified types and amounts of insurance coverage. Accordingly, the Lease requires Sunstone to submit to the City financial and operating reports and certified copies of insurance policies.

For Calendar Year 2012, Sunstone paid the City rent of $1,772,194, consisting of the Base Rent of $683,032 and the specified minimum Percentage Rent of $1,089,162. (See Appendix I Sunstone Reported Occupancy, Revenues, and Expenses, and Rents Paid, CY 2008 through CY 2012.)

Objectives

The objectives of this audit were to determine whether Sunstone Hotel Investors, Inc.:

- Accurately and completely recorded and reported revenues;

---

[6] In June 1981, the New York State Urban Development Corporation, doing business as the Empire State Development Corporation (ESDC), and the City created the 42nd Street Development Plan to rehabilitate and renew the area of midtown Manhattan surrounding West 42nd Street between Broadway and Eighth Avenue. As part of this effort, in November 1998, an ESDC subsidiary and FC 42 Hotel, LLC, entered into a 97-year and one-month construction Lease that obligated the FC 42 Hotel, LLC to construct and operate the Hilton, which is composed of 460 guest rooms, 5,500 square feet of meeting facilities, a restaurant, and a bar.

[7] "Property" is defined in Article 1, Section 1.01 of the Lease as "the Land and the Improvements" and "Improvements" is defined in Article I, Section 1.01 of the Lease as "any buildings and structures, and any building machinery, equipment, and fixtures…affixed to and forming a part of the buildings and structures, which may be erected or located wholly or partially on the Land."

[8] "Initial Total Hotel Project Cost" is defined in Article 1, Section 1.01 of the Lease as "the estimated cost of completing the Construction Work and preparing the Hotel Project for opening, as set forth in the development budget last approved by Tenant's construction lender prior to or in connection with closing the Construction Loan" on November 13, 1998.

- Accurately calculated and paid the Base and Percentage Rents, and submitted its payments on time;
- Maintained adequate internal controls over the recording and reporting of its revenues; and
- Complied with other significant Lease terms.

Scope and Methodology Statement

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

The scope of this audit covers the period from January 1, 2011, to December 31, 2012. Please refer to the Detailed Scope and Methodology at the end of this report for the specific procedures and tests that were conducted.

Discussion of Audit Results

The matters covered in this report were discussed with Sunstone and EDC officials during and at the conclusion of this audit. A preliminary draft report was sent to Sunstone and EDC officials and discussed at an exit conference on May 27, 2014. On October 29, 2014, we submitted a draft report to Sunstone and EDC with a request for comments. We received written responses from Sunstone and EDC officials on November 13, 2014 and November 14, 2014, respectively.

In their responses, both Sunstone and EDC maintained that when calculating Percentage Rent, ATHPC was not overstated and asserted that ITHPC should be $113.3 million based, in large part, on a sample development budget included in the Lease. Sunstone stated that "the 'total assets' value set forth in FC's audited financial statements for its fiscal year ended January 31, 2001 (i.e., $113,330,682), is within $500 of the 'sample' development budget value of $113,330,262….Of the presently available information, the audited financial statements of FC (especially when coupled with the 'sample' development budget value) are the most reliable data for determining the development budget for construction of the Hotel….Sunstone asserts that, when calculating Percentage Rent under the Lease, the value to be used for 'Total Project Cost' should be either $113,330,682 or $113,330,262."

Similarly, EDC stated "[s]ince the Date of Lease, FC and Sunstone have used $113,330,262 as the Initial Total Hotel Project Cost (ITHPC) in their calculation of Percentage Rent. This number is derived from the detailed development budget in Schedule P of the Lease dated November 3, 1998." Further, EDC stated that its contracted CPA firm, loan requisition forms, and loan ratios also support the use of this figure. Therefore, EDC indicated that it will execute a written supplement setting forth $113,330,262 as the ITHPC.

Sunstone also asserted that it does not owe any money to the FF&E reserve account and moreover, that "the FF&E reserve account has been overfunded for the Period, leaving a credit balance in favor of Sunstone in the amount of $2,617,669. Accordingly, Sunstone disagrees with the findings in the draft audit report that Sunstone is required to deposit additional funds into the FF&E reserve account." EDC agreed "that maintaining a FF&E account is appropriate" and EDC indicated that it "intends to ensure that the proper amount is funded and maintained in the future." However, EDC did not agree to ensure that Sunstone replenishes the audit-recommended $4,424,615 to the FF&E reserve account.

With regard to the report's remaining findings, both Sunstone and EDC indicated that they already did or will in the future implement the report's recommendations.

As the Lease administrator, EDC has a responsibility to ensure that Sunstone fulfills its Obligations, properly calculates Percentage Rent, and makes all Lease-required payments. Since Percentage Rents are based, in part, on ITHPC throughout the life of the 97-year Lease ending December 12, 2095, it is not reasonable or appropriate to accept other indications of ITPHC in place of Lease-required evidence. The Lease and the Building Loan Agreement explicitly required that ITHPC be based on the development budget which was last approved by the lender, duly executed, in recordable form, and received and approved by the Administrative Agent. Sample budgets, financial statements, loan requisitions, and loan ratios—independently or in conjunction with one another—do not constitute and are not a substitute for Lease-required evidence. EDC should ensure Lease compliance by determining the proper value of ITHPC as required by the Lease rather than rely on a sample budget.

Additionally, Sunstone does in fact owe $4,424,615 to the FF&E reserve account ($3,093,862 for contributions that were not made or maintained, $908,721 for interest, and $422,032 for improper disbursements). Sunstone's assertion that it overfunded the FF&E reserve account is based largely on a $3,450,000 contribution that Sunstone claimed that it made in 2010. However, these funds were not deposited in and do not relate to Sunstone's Lease-required FF&E Replacement Reserve account. Instead, these funds were deposited in and relate to a separate loan refinancing agreement required reserve account. Therefore, Sunstone should replenish $4,424,615 to the FF&E reserve account. If Sunstone does not immediately replenish the FF&E reserve account, EDC should send Sunstone a written notice demanding that it replenish $4,424,615 to the FF&E reserve account within 30 days and pursue all remedies available to it under the Lease if Sunstone does not comply.

Except for the inclusion of the Building Loan Agreement and Project Loan Agreement as exhibits, which were too voluminous to include as an attachment to the report, the full text of Sunstone's and EDC's written responses were included as addenda to this report. Those exhibits are available in our office.

FINDINGS

The audit found that Sunstone generally maintained adequate controls over its revenue recording and reporting processes and paid the Base Rent due the City in a timely manner. However, our review also found that Sunstone: (1) improperly calculated the Formula Percentage Rent; (2) miscalculated the Percentage Rent based on a misinterpretation of the Formula Percentage Rent; and (3) did not comply with other significant Lease terms. Sunstone appears to have overstated ATHPC by as much as $19.8 million and understated AGR by $1 million due to the improperly calculated Formula Percentage Rent. Sunstone also did not make or maintain required FF&E reserve contributions totaling $3.1 million and improperly disbursed FF&E funds totaling $7.3 million. In addition, we observed that EDC did not adequately monitor Sunstone to ensure its compliance with Lease terms. In both its roles first, as a reversionary interest holder and later, as the Lease administrator, EDC should have ensured that Sunstone complied with rent and all other Lease terms.

These matters are discussed in detail in the following sections of this report.

Sunstone Improperly Calculated the Percentage Rent

Sunstone improperly calculated the Formula Percentage Rent due the City since 2006 when it purchased the Hilton leasehold interest. As noted, Sunstone was required to pay the City a Percentage Rent that was the greater of a specified minimum amount or a Formula Percentage Rent based on ATHPC and AGR. However, Sunstone appears to have overstated ATHPC by as much as $19.8 million and understated AGR by $1 million (see Appendix II Comparative 2011 ATHPC and Formula Percentage Rent Calculations) as described below.

- Sunstone used a “sample” development budget included in the Lease rather than the budget last approved by the original Tenant’s construction lender as the basis for the ITHPC as is required by Article 1, Section 1.01 of the Lease. Based on the “sample” development budget, Sunstone claimed ITHPC of $113.3 million when calculating its Formula Percentage Rent. However, the initial construction mortgage obtained in 1998 was for $73.7 million, which suggests that the actual cost may have been lower than the pro forma cost in the “sample” budget. Absent the actual construction budget approved by the original construction lender which is required by the Building Loan Agreement, Sunstone does not have sufficient evidence to support the $113.3 million used to calculate the Percentage Rent. Disallowing the unsubstantiated ITHPC of $39.6 million (i.e., the claimed amount of $113.3 million less the initial construction mortgage amount of $73.7 million) would reduce ATHPC by as much as $19.8 million. In February 2012, in its audit of Sunstone’s Lease compliance for Calendar Years 2009 and 2010, EDC’s contracted CPA firm also questioned Sunstone’s claimed ITHPC of $113.3 million and noted that a lesser ITHPC could result in Percentage Rent recoveries.

  Subsequent to our exit conference, on behalf of the original Tenant, Forest City Ratner Companies provided us copies of loan disbursement requests and asserted that original budget amounts that Forest City Ratner reports in them “should constitute the Approved Construction Budget.” However, loan disbursement requests do not constitute and are not a substitute for a formally approved lender construction budget which was required by the Building Loan Agreement. Specifically, Article IV, Section 4.2 (eee) of the Building Loan Agreement states “[t]he Administrative Agent shall have received and approved the following items and documents, duly executed and in recordable form where applicable… a copy of the Budget." Indeed, these are solely representations by Forest City Ratner and do not themselves substantiate the amount of the approved budget.

Sunstone Response: "Of the presently available information, the audited financial statements of FC (especially when coupled with the 'sample' development budget value) are the most reliable data for determining the development budget for construction of the Hotel. We know that the initial November 13, 1998 construction mortgage amount was $73.7 million, the 'sample' development budget dated November 3, 1998 was $113.3 million, and that FC's financial records reflected 'total assets' of $113.3 million as of January 31, 2001. Accordingly, we know that the initial construction mortgage amount of $73.7 million divided by $113.3 million represents a 65% loan-to-construction budget, which seems like a very fair representation of construction lending practices at the time in question."

EDC Response: "Since the Date of Lease, FC and Sunstone have used $113,330,262 as the Initial Total Hotel Project Cost (ITHPC) in their calculation of Percentage Rent. This number is derived from the detailed development budget in Schedule P of the Lease dated November 3, 1998....

MP, in their lease audit, said that although Sunstone was unable to provide them with a signed final development budget, 'it is possible given the November 5, 1998 date of the Lease and the November 13, 1998 date of the initial mortgage that the pro-forma document included in the lease was indeed, the final development budget approved by the lender.'

On July 25, 2014, FC provided requisitions submitted to the Administrative Agent for the Building Loan Agreement in 1998 (Requisition #1) and later in 2000 (Requisition #17) which further established the approved construction budget. Both requisitions included a construction budget of $113,330,262, the same as in Schedule P of the Lease….

The Comptroller's Audit Report, however, indicates that the ITHPC might be overstated and could be as low as $73,665,000. EDC does not concur with this analysis, which fails to take into account <u>all</u> the sources of funds for the project such as equity of $24,665,262 and a mezzanine loan from Hilton (Promus) of $15,000,000 as detailed in Requisition #I. In our view, it would have been highly unlikely to be able to finance a new, to be built hotel 100% with senior construction debt….

While there may not be any document that explicitly says 'lender-approved construction budget'; based on the information above, EDC and the tenants have reasonably and properly concluded that the $113,330,262 in Schedule P of the Lease, is the development budget approved by Tenant's construction lender prior to or in connection with closing the Construction Loan and ITHPC."

Auditor Comment: Since Percentage Rents are based, in part, on ITHPC throughout the life of the 97-year Lease ending December 12, 2095, it is not reasonable or appropriate to accept other indications of ITPHC in place of Lease-required evidence. The Lease and the Building Loan Agreement explicitly required that ITHPC be based on the development budget which was last approved by the lender, duly executed, in recordable form, and received and approved by the Administrative Agent. Financial statements, sample budgets, loan requisitions, and loan ratios—independently or in conjunction with one another—do not constitute and are not a substitute for Lease-required evidence.

Additionally, EDC cannot simultaneously claim that it relied on its contracted CPA firm to "ensure proper lease compliance," and cherry pick which of its contracted CPA firm's statements it will present and consider. Just as we did, EDC's contracted CPA firm questioned Sunstone's claimed ITHPC of $113.3 million because Sunstone "was unable to provide the final development budget and evidence of its approval" and "the initial mortgage was $73,665,000 – significantly less than the $113,330,262 of Initial Total Hotel Project Cost claimed," and noted that a lesser ITHPC could result in additional rents for the City, and recommended that EDC "determine the proper value of Initial Total Hotel Project Cost." EDC's contracted CPA firm noted only that it was "possible" that "a pro-forma budget which was included, (as an example of format) in the original Lease" was the final approved development budget. As the Lease administrator, EDC should ensure Lease compliance by determining the proper value of ITHPC as required by the Lease and recommended by EDC's contracted CPA firm rather than simply accept the possibility that the sample budget is the final approved development budget.

- Additionally, based on our review of sampled 2011 expenditures, Sunstone understated AGR by $1 million because it improperly deducted expenses that were: (1) not incurred during the period; (2) duplicative, prohibited or limited by the Lease; or (3) not related to the operation of the Hilton. A significant portion of the $1 million was composed of sums identified as "Recapture Amount"[9] totaling $452,638 related to and payable in the "2nd PILOT Period"[10] (i.e., May 1, 2020 through December 12, 2095) and duplicative FF&E expenses of approximately $300,000. Our review indicated that Sunstone improperly deducted these same types of expenses each year from 2006 through 2012.

Sunstone also misinterpreted Part (I) of the Formula Percentage Rent. Specifically, Section 3.02 (a) of the Lease stipulates that after the first Third-Party Sale, the Formula Percentage Rent is equal to:

> (I) Twelve percent (12%) of the amount, if any, by which the lesser of (1) Adjusted Gross Revenues for such Lease Year and (2) the product of (x) fourteen percent (14%) and (y) Adjusted Total Hotel Project Cost exceeds the product of (aa) twelve percent (12%) and (bb) Adjusted Total Hotel Project Cost; plus
>
> (II) Eighteen percent (18%) of the amount, if any, by which Adjusted Gross Revenues for such Lease Year exceeds the product of (x) fourteen percent (14%) and (y) Adjusted Total Hotel Project Cost. (Emphasis added.)

As noted, this formula is expressed as follows:

[9] "Recapture Amount" is defined in Article 3, Section 3.05 of the Lease as "an amount equal to one-tenth of the Aggregate Annual Recapture Amount (as hereinafter defined), and the term 'Aggregate Annual Recapture Amount' shall mean the amount, determined in the aggregate for the 1st PILOT Period, equal to the difference between (i) Projected Full Taxes for all of the Lease Years during such period and (ii) the sum of (A) Base Rent for all of the Lease Years during such period and (B) the Percentage PILOT Rent for all of the Lease Years during such period, but in no event shall the Aggregate Annual Recapture Amount be less than zero."

[10] The "2nd PILOT Period" is defined in Article 1, Section 1.01 of the Lease as "the period commencing on the 2nd PILOT Period Commencement Date and ending on the Expiration Date. The 2nd PILOT Period Commencement Date is defined in Article 1, Section 1.01 of the Lease as "the day immediately following the end of the 1st PILOT Period." The term 1st PILOT Period is defined in Article 1, Section 1.01 of the Lease as "the period commencing on the first day of the Lease Year in which the Hotel Project opens for business to the public and ending on the day immediately preceding the twentieth (20th) anniversary of the Rent Commencement Date (or if the Rent Commencement Date is a day other than the first of the month, then ending on the last day of the month immediately preceding the month in which the twentieth (20th) anniversary of the Rent Commencement Date shall occur)."

12% [(The < of: AGR or 14% ATHPC) – 12% ATHPC] + 18% (AGR – 14% ATHPC).

However, Sunstone misinterpreted the formula to read as follows:

12% [The < of: AGR or (14% ATHPC – 12% ATHPC)] + 18% (AGR – 14% ATHPC),

or in effect,

12% (The < of: AGR or 2% ATHPC) + 18% (AGR – 14% ATHPC).

The proper application of the Formula Percentage Rent did not result in additional Percentage Rents for the City. In fact, the proper application of the Formula Percentage Rent may result in lower Formula Percentage Rent. (See Appendix III Comparative 2011 Formula Percentage Rent Methodologies and Calculations.)

Sunstone Did Not Comply with Other Significant Lease Terms

Sunstone Did Not Make FF&E Contributions Totaling $3.1 Million

Sunstone did not make required FF&E reserve contributions totaling $3,093,862. Upon purchasing the Hilton in 2006, Sunstone was to replenish $2,130,444 to the FF&E reserve account on behalf of the Seller. Thereafter, Sunstone was required under the Lease to annually either contribute the greater of 3 percent of Gross Revenues for such Lease Year or the amount required by the Recognized Mortgagee then most senior in lien to be contributed to the FF&E Replacement Reserve for each such Lease Year. However, Sunstone did not fund and maintain the account as required. Specifically, Sunstone did not replenish $2,130,444 to the FF&E reserve account and when Sunstone closed its initial FF&E reserve account in 2010, it did not transfer the balance of $963,418 to the newly-opened account.

Because Sunstone did not make or maintain required FF&E reserve contributions of $3,093,862, it did not accrue interest of $908,721,[11] and ultimately, $4,002,583 was not available and was not used for the replacement and refurbishment of FF&E. Further, for contributions that were made (i.e., the $963,418), Sunstone twice claimed these amounts as Operating Expenses and deducted them from Gross Revenues—once as reported contributions to the FF&E reserve account and again, as reported hotel expenses paid from unrestricted funds. As a result, by taking these duplicative deductions, Sunstone understated its AGR which reduced the Formula Percentage Rent due the City.

> ***Sunstone Response:*** "Below are certain data points that clearly delineate and support Sunstone's positions that (a) Sunstone, contrary to the assertion in the draft audit report, has continuously contributed at least three percent (3%) of gross revenues into the FF&E reserve account, and (b) Sunstone does not owe additional monies to the FF&E reserve account.
>
> > *$447,500,396 = gross revenues at the Hotel from March 2006 through September 30, 2014….

[11] We assessed interest at the prime rate from the date contributions should have been made or maintained through April 30, 2014.

*$15,555,456 = three percent (3%) of the Hotel's gross revenues for the Period, comprised of $13,425,012 plus the initial contribution from FC of $2,130,444….

*$18,173,125 = Sunstone's actual contribution into the FF&E reserve account….

*$34,372,430 = Sunstone's investments into the Hotel for the Period, of which $31,131,351 are qualified FF&E expenses under the lease.

As set forth above, the FF&E reserve account has been overfunded for the Period, leaving a credit balance in favor of Sunstone in the amount of $2,617,669. Accordingly, Sunstone disagrees with the findings in the draft audit report…."

Auditor Comment: In its response (Exhibit D), Sunstone acknowledged that it did not replenish $2,130,444 to the FF&E reserve account on behalf of the Seller in 2006 and that it withdrew $963,418 from its FF&E reserve account in 2010. Sunstone maintained that it made up for this combined FF&E shortfall of $3,093,862 and that it overfunded its FF&E reserve account largely by contributing $3,450,000 to its FF&E reserve account in 2010. However, these funds were not deposited in and do not relate to Sunstone's Lease-required FF&E Replacement Reserve account. Instead, these funds were deposited in and relate to a separate loan refinancing agreement required reserve account.

Additionally, Sunstone claimed that it overfunded its FF&E reserve account because its total contributions were greater than 3 percent of total Gross Revenues for the period March 2006 through September 2014. However, as noted, the Lease required Sunstone to contribute to its FF&E reserve account *the greater of* 3 percent of Gross Revenues or a mortgagee required amount for each Lease Year. Mortgagee required contributions that are greater than 3 percent of Gross Revenues represent the FF&E Replacement Reserve Floor (i.e., the minimum payment).

Sunstone Did Not Use FF&E Funds for Their Intended Purposes

Between 2006 and 2010, Sunstone failed to submit or maintain documents required by the Lease that demonstrated that it properly disbursed FF&E funds totaling $6,883,534. Further, a review of a sample of 2011 expenses claimed as FF&E expenses revealed that Sunstone improperly disbursed $422,032 of $560,551 (75.3 percent) of the sampled expenses.

The Lease stated that FF&E:

> shall mean fixtures, furniture, furnishings, decorations, artwork, carpets, draperies, floor coverings, fittings, equipment, machinery, apparatus, appliances and all parts and supplies pertaining thereto and other articles of tangible personal property used or usable in connection with operation of the Hotel Project, including lobby and guest room furniture; the front desk; kitchen appliances and equipment; television sets, office furniture and equipment such as safes, cash registers and accounting, computer, duplicating and communication equipment; telephone equipment; laundries; dry cleaning facilities; furniture and equipment used in connection with the operation of restaurants, bars and cocktail lounges; decorative lighting; material handling equipment, cleaning and engineering equipment and all other fixtures, equipment, apparatus and personal property

> needed for such purposes; china, glassware, stemware, silverware, linens, sheets, bedspreads, pillowcases, towels, face cloths, bath mats, bath rugs, shower curtains, blankets, tools, employees' uniforms; and any other equipment, goods, utensils, supplies or reserve stock, subject to such depletions, resupplies, substitutions and replacements as shall occur and be made in the normal course of business; motor vehicles (including courtesy vans and limousines).

The Lease further stated that FF&E expenses were "Operating Expenses." As Operating Expenses, the Lease allowed Sunstone to deduct FF&E contributions from Gross Revenues when calculating Percentage Rent due the City.

To ensure that FF&E funds were properly disbursed, Sunstone was required to annually submit to ESDC or EDC FF&E budgeted and actual utilizations reports and explanations of variances. However, Sunstone did not submit such reports for CY 2006 through CY 2010. Moreover, Sunstone failed to maintain required documentation evidencing how it spent 2006 through 2010 FF&E funds totaling $6,883,534. Consequently, we could not determine whether these funds were used for their intended purposes. Further, while Sunstone submitted required utilization reports for CY 2011, its own documentation reflected that it failed to properly disburse most of those funds. Based on our review of $560,551 of $851,503 CY 2011 FF&E expenses, Sunstone improperly used $422,032 (75.3 percent) for capital repairs (i.e., curtain wall, facade, and roof repairs), which did not qualify as FF&E expenses and were not deductible under the Lease.

Additionally, in CY 2011, Sunstone did not use FF&E funds to pay for qualifying FF&E expenses, such as linens and uniforms, totaling approximately $300,000. Instead, Sunstone classified these as supply and equipment expenses. In doing so, Sunstone took duplicative deductions for FF&E qualifying expenses—once upon reported contribution to the FF&E reserve account and again upon disbursement from an unrestricted account.

Sunstone Did Not Submit Required Financial and Operating Reports to Oversight Agencies

Sunstone did not submit to ESDC and EDC required financial and operating reports including: annual audited property-level financial statements; monthly hotel industry reports comparing Hilton's performance to that of the Competitive Set[12] regarding occupancy, average room rate, and other data; property inspection reports; and certified FF&E reserve account depository statements, and budgeted and actual utilizations reports with explanations of variances. These reports enable ESDC and EDC to determine whether Sunstone paid all rents due and met lease-stipulated performance standards and to determine other appropriate actions, including issuance of rent demand notices and invocation of management termination clauses.

For Calendar Years 2009 and 2010, EDC's contracted CPA firm cited Sunstone for "deficiencies in the Tenant compliance with several key reports that may be critical to NYCEDC's management of the fee interest." Subsequently, in February and December 2012, EDC asked that Sunstone provide EDC with required reports in the form and time frames prescribed by the Lease. However, EDC did not follow up on this issue notwithstanding the fact that Sunstone continued to violate its Lease reporting requirements. In the absence of financial and operating reports, ESDC and EDC could not effectively assess, monitor, and hold Sunstone accountable for its performance. This is

[12] "Competitive Set" is defined in Article 1, Section 1.01 of the Lease as listed and revised based on "hotels in Manhattan most closely similar to the Hotel Project in terms of market segment, size, quality, location, amenities and physical condition."

of particular concern because the Hilton's revenues decreased drastically from 2008 to 2010, and Sunstone terminated its hotel manager in 2011.

EDC Did Not Adequately Monitor Sunstone to Ensure Compliance with the Lease

EDC did not adequately monitor Sunstone to ensure that it complied with Lease terms. As the Lease administrator, EDC should have ensured that Sunstone complied with the terms of the Lease. However, our review found that EDC did not. Specifically, our review revealed the following:

- EDC failed to conduct routine financial reviews or audits to determine whether Sunstone properly calculated Percentage Rents, made or maintained required FF&E reserve contributions, and used FF&E reserve funds for their intended purposes. In October 2011, EDC engaged a CPA firm to perform a Lease compliance review for the period January 2009 through December 2010. However, the contracted CPA firm in its review did not adequately examine AGR, FF&E reserve contributions, and FF&E expenditures.

- EDC failed to follow up on significant issues that the contracted CPA firm identified. For example, EDC's contracted CPA firm questioned Sunstone's ITHPC figure of $113.3 million because it was based on a sample development budget and was far greater than the initial mortgage of $73.7 million, and noted that a lesser ITHPC could have resulted in Percentage Rent recoveries. Accordingly, the contracted CPA firm recommended that EDC independently determine the appropriate amount of ITHPC. However, EDC failed to do that. Additionally, as noted, EDC did not follow up on Sunstone's failure to submit required financial and operating reports.

- EDC did not review and approve documents required by the Lease that were critical to the calculation of the Formula Percentage Rent. In addition, these required documents, had they been properly produced, would have formed the basis for the City asserting Lease-based remedies for unsatisfactory performance. Most notably, EDC failed to retain a copy of the final lender-approved development budget and to execute a written Lease Supplement that set forth the ITHPC. As discussed above, the ITHPC forms a critical part of the Formula Percentage Rent due the City throughout the Lease term ending December 12, 2095. Additionally, EDC did not review and approve Sunstone's Management Agreement to ensure that management fees, deductible under the Lease, were reasonable and appropriate. More importantly, EDC did not ensure that lease-stipulated performance standards and termination clauses were incorporated in the Management Agreement.

RECOMMENDATIONS

Sunstone should:

1. When calculating ATHPC, and in turn the Formula Percentage Rent, use ITHPC as stipulated by the development budget last approved by the construction lender prior to or in connection with closing the Construction Loan.[13]

   Sunstone Response: "[T]he 'total assets' value set forth in FC's audited financial statements for its fiscal year ended January 31, 2001 (i.e., $113,330,682) is within $500 of the 'sample' development budget value of $113,330,262….

   Of the presently available information, the audited financial statements of FC (especially when coupled with the 'sample' development budget value) are the most reliable data for determining the development budget for construction of the Hotel….

   Sunstone asserts that, when calculating Percentage Rent under the Lease, the value to be used for 'Total Project Cost' should be either $113,330,682 or $113,330,262."

   Auditor Comment: The Lease and the Building Loan Agreement explicitly required that ITHPC be based on the development budget which was last approved by the lender, duly executed, in recordable form, and received and approved by the Administrative Agent. Financial statements, sample budgets, loan requisitions, and loan ratios—independently or in conjunction with one another—do not constitute and are not a substitute for Lease-required evidence.

2. When calculating AGR, and in turn the Formula Percentage Rent, deduct Operating Expenses as stipulated and limited by the Lease.

   Sunstone Response: **"**Sunstone will continue to deduct Operating Expenses pursuant to the terms of the Lease when determining Percentage Rent. Note, the draft audit report expressly states that NO additional Percentage Rent is due Landlord as a result of any previous incorrect calculation of AGR."

   Auditor Comment: In the past, Sunstone did not deduct Operating Expenses pursuant to the terms of the Lease. As detailed in the report, Sunstone improperly deducted expenses that were: (1) not incurred during the period; (2) duplicative, prohibited or limited by the Lease; or (3) not related to the operation of the Hilton. Sunstone is correct in asserting that no additional Percentage Rents were due the City as a result of improperly calculating AGR. However, this is true only because the minimum Percentage Rent specified in the Lease for the scope period has been greater than the alternative Formula Percentage Rent properly calculated. That will change in the later years of the Lease, at which time this recommendation could have a material effect on the amount of rent paid to the City.

3. Properly calculate the Formula Percentage Rent.

[13] "Construction Loan" is defined in Article 31, Section 31.01 of the Lease as "the loan to finance a portion of the Construction Work." Construction Work is defined in Article 1, Section 1.01 of the Lease as "all work to be performed in connection with, and which is necessary to complete, the initial construction of the Hotel Project."

Sunstone Response: "Sunstone correctly calculated Percentage Rent in accordance with 'Example of Calculation of Percentage Rent,' as set forth in Exhibit A of the Lease; however, Sunstone is amenable to having the Lease amended to reflect the Percentage Rent formula purported to be the 'proper' formula in the draft audit report and as suggested by the EDC. Accordingly, Sunstone requests that Exhibit A of the Lease be amended to finally resolve any ambiguities between the formula language and the Lease exhibit."

4. Replenish $4,424,615 to the FF&E reserve account ($3,093,862 for contributions that were not made or maintained, $908,721 for interest, and $422,032 for improper disbursements).

5. Make and maintain FF&E contributions as required by the Lease.

Sunstone Response to Recommendation Numbers 4 and 5: "As set forth above, the FF&E reserve account has been overfunded for the Period, leaving a credit balance in favor of Sunstone in the amount of $2,617,669. Accordingly, Sunstone disagrees with the findings in the draft audit report…."

Auditor Comment: As detailed in the report and acknowledged by Sunstone in its response (Exhibit D), Sunstone did not make and maintain required FF&E reserve contributions and Sunstone did not in fact overfund its FF&E reserve account. Therefore, Sunstone should immediately replenish $4,424,615 to the FF&E reserve account.

6. Use FF&E reserve account funds only for FF&E qualifying expenses as stipulated by the Lease.

Sunstone Response: "Sunstone will continue to use FF&E reserve account funds pursuant to the terms of the Lease."

Auditor Comment: In the past, Sunstone did not use FF&E reserve account funds pursuant to the terms of the Lease. As detailed in the report, Sunstone failed to submit or maintain Lease-required documents that demonstrated that it properly disbursed FF&E funds totaling $6,883,534 between 2006 and 2010. Further, Sunstone's own documentation reflected that it improperly disbursed $422,032 of $560,551 (75.3 percent) of sampled 2011 FF&E funds.

7. Maintain documentation evidencing how FF&E funds are used as required by the Lease.

Sunstone Response: "Contrary to the assertion in the draft audit report, Sunstone has provided either or both the EDC and Landlord with FF&E utilization reports for years 2006 through 2013. Sunstone will continue to provide EDC with FF&E utilization reports as required by the Lease.

Furthermore, in order to standardize the reporting process, Sunstone and the EDC must reach an agreement as to (a) the identity/ies of the EDC recipients for the FF&E utilization reports required under the Lease, (b) the mode for delivery (i.e., email, FedEx, etc.) and (c) the form of reports (i.e., confirmation of whether Exhibit E hereto is acceptable)."

Auditor Comment: In the past, Sunstone did not maintain documentation evidencing how FF&E funds were used. As detailed in the report, Sunstone failed to submit or maintain Lease-required utilization reports and documentation, such as contracts, invoices, and canceled checks, to demonstrate that it properly disbursed FF&E funds totaling $6,883,534 between 2006 and 2010.

8. Submit to EDC, in the manner and time frames specified by the Lease, required financial and operating reports including but not limited to: annual audited property-level financial statements; monthly STR reports comparing Hilton's performance to that of the Competitive Set regarding occupancy, average room rate, and other data; property inspection reports; and certified FF&E reserve account depository statements, and budgeted and actual utilization reports with explanations of variances.

   Sunstone Response: "Sunstone believes that it is currently complying with the reporting requirements of the Lease. In respect to Section 17.01 (c) of the Lease, Sunstone has provided the EDC with annual consolidated financial statements, audited by Ernst & Young, which includes Sunstone as required by the Lease. The Lease does not specify that property-level financial statements are required. However, Sunstone is amenable to providing the EDC with audited property-level financial statements for Sunstone's fiscal year ending December 31, 2014 and forward. To that end, we request the EDC to confirm that (a) audited property-level financial statements for years 2014 and forward will be acceptable, and (b) the EDC is NOT seeking to have audits of financial statements for prior years.

   Sunstone will continue to provide the EDC with monthly STR reports as required by the Lease. In addition, Sunstone will continue to provide the EDC with FF&E reserve account depository statements, FF&E budget reports and actual FF&E utilization reports, all as required by the Lease. We request the EDC to confirm that the reports attached hereto as <u>Exhibit E</u> and <u>Exhibit F</u> are acceptable in so far as Sunstone is obligated to provide FF&E utilization and budget reports, respectively. We also request the EDC to confirm (a) the identity/ies of the EDC recipients for the aforementioned periodic reports and (b) the mode for delivery (i.e., email, FedEx, etc.)."

   Auditor Comment: In its response, Sunstone incorrectly asserted that in the past, Sunstone submitted to EDC monthly STR reports in the manner and time frames specified by the Lease. Further, Sunstone does not in its response fully or properly address certain other reporting requirements. We stand by our recommendation that Sunstone should submit to EDC, in the manner and time frames specified by the Lease, property inspection reports, *certified* FF&E reserve account depository statements, and budgeted and actual utilization reports with explanations of variances.

Regarding Sunstone, EDC should:

9. Investigate and determine the proper ITHPC as stipulated by the development budget last approved by the construction lender prior to or in connection with closing the Construction Loan.

   EDC Response: "A valid ITHPC has been determined….Since the Date of Lease, FC and Sunstone have used $113,330,262 as the Initial Total Hotel Project Cost (ITHPC) in their calculation of Percentage Rent. This number is derived from the detailed development budget in Schedule P of the Lease dated November 3, 1998."

   Auditor Comment: A valid ITHPC has not been determined. The Lease and the Building Loan Agreement explicitly required that ITHPC be based on the development budget which was last approved by the lender, duly executed, in recordable form, and received and approved by the Administrative Agent. Financial statements, sample budgets, loan requisitions, and loan ratios—independently or in conjunction with one another—do not constitute and are not a substitute for Lease-required evidence.

10. Execute a written supplement to the Lease setting forth the ITHPC as required by Section 6.09 of the Lease.

    EDC Response: "EDC will follow-up and execute a written supplement setting forth $113,330,262 as the ITHPC."

    Auditor Comment: A valid ITHPC has not been determined and so EDC's response does not adequately address the audit findings. The Lease and the Building Loan Agreement explicitly required that ITHPC be based on the development budget which was last approved by the lender, duly executed, in recordable form, and received and approved by the Administrative Agent. As the Lease administrator, EDC should ensure Lease compliance by determining the proper value of ITHPC as required by the Lease and recommended by EDC's contracted CPA firm rather than use a figure included in a sample budget.

11. Ensure that Sunstone properly calculates the Formula Percentage Rent in accordance with the Lease.

    EDC Response: "Sunstone has been calculating Percentage Rent based on the Example of Percentage Rent Calculation in Exhibit A of the Lease. This is the same way it has been calculated since 1998 and accepted by 42DP, however, it is different from how it is written in the body of the Lease which is the basis of the Comptroller's finding.

    EDC has reviewed the methodology presented in the Comptroller's Audit Report and agrees with the interpretation. We also agree that that this will not result in additional rent for the audit period. Due to the discrepancy however, EDC believes that a clarification of the Lease is necessary and will engage Sunstone in this regard. EDC will also ensure that Sunstone calculates the Percentage Rent accordingly."

12. Routinely demand and review the monthly and annual reports submitted by Sunstone to ensure the accuracy of the calculation of the Formula Percentage Rent.

    EDC Response: "EDC reviews the Quarterly and Annual Verified Statement of Percentage Rent and Adjusted Gross Revenues reports submitted by Sunstone. Nevertheless, EDC agrees with this recommendation and going forward plans to routinely demand and review the required monthly and annual reports to ensure the accuracy of the Percentage Rent calculation in accordance with the clarification discussed above."

13. Ensure that Sunstone replenishes $4,424,615 to the FF&E reserve account.

    EDC Response: "EDC agrees that maintaining a FF&E account is appropriate and intends to ensure that the proper amount is funded and maintained in the future."

    Auditor Comment: As the Lease administrator, EDC has a responsibility to ensure that Sunstone fulfills its Obligations and makes all Lease-required payments. As detailed in the report, Sunstone did not make and maintain required FF&E reserve contributions and improperly disbursed FF&E funds. Therefore, Sunstone should replenish $4,424,615 to the FF&E reserve account ($3,093,862 for contributions that were not made or maintained, $908,721 for interest, and $422,032 for improper disbursements). If Sunstone does not immediately replenish $4,424,615 to the FF&E reserve account, EDC should send Sunstone a written notice demanding that it replenish $4,424,615 to the FF&E reserve account within 30 days and pursue all remedies available to it under the Lease if Sunstone does not comply.

14. Ensure that Sunstone submits to EDC, in the manner and time frames specified by the Lease, required financial and operating reports including but not limited to: annual audited property-level financial statements; monthly STR reports comparing Hilton's performance to that of the Competitive Set regarding occupancy, average room rate, and other data; property inspection reports; and certified FF&E reserve account depository statements, and budgeted and actual utilization reports with explanations of variances.

    EDC Response: **"**EDC agrees that receipt of these reports is important and will monitor and enforce the Lease as it relates to these requirements. Sunstone has indicated that prospectively they will provide annual audited property-level financial statements as well as the other required reports and work with EDC to assure they are in acceptable form."

DETAILED SCOPE AND METHODOLOGY

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

The scope of this audit was Calendar Years 2011 and 2012. We conducted additional reviews prior to this period to verify the accuracy of the reported ITHPC, ATHPC, and FF&E Replacement Reserve.

To identify and understand Sunstone's contractual obligations with the City, we reviewed and abstracted the terms of the lease agreement dated November 5, 1998, and related documents. To obtain an understanding of the Hilton's operations, we conducted a property tour and internet research to ascertain the Hilton's services and the related charges.

To assess Sunstone's internal controls over its revenue recording and reporting processes, we conducted walkthrough meetings with Sunstone's contracted hotel management company—Highgate Hotels, L.P. (Highgate)—regarding room, food and beverage (F&B), banquet revenues, and information system controls. We also observed demonstrations of the respective revenue recording and reporting computer systems— OnQ, Micros and Delphi[14] — and reviewed system manuals. We documented our understanding through written narratives and flowcharts. Additionally, we reviewed Sunstone's management and franchise agreements, internal audit reports, accounting policies and procedures, verified statements, and financial records.

To perform preliminary analyses, we traced the amounts from the Hilton's trial balance to the general ledger as of December 31, 2011, and compared them with the amounts reported in Sunstone's annual verified statements for consistency. To identify any significant fluctuations in Gross Revenues and Operating Expenses, we prepared a five-year trend analysis based on reported information from Sunstone's annual verified statements for 2007 through 2011.

To determine whether Sunstone paid the reported Base and Percentage Rents and whether it did so on a timely basis, we verified Sunstone's rent payments with ESDC's and EDC's rent collection records for 2011 and 2012. To determine whether Sunstone accurately calculated its Base Rent for 2011 and 2012, we recalculated the rent amounts payable based on the formula stipulated in Section 3.01 of the lease agreement. To determine whether Sunstone accurately calculated its Percentage Rent for 2011 and 2012, we established the calculation methodology based on the formula stipulated in Section 3.02 of the lease agreement. To verify the accuracy of the reported ITHPC, we requested but were unable to obtain a written supplement that was supposed to have been executed in 1998, in accordance with Section 6.09 of the lease agreement. To determine the ATHPC, we reviewed the Agreement of Purchase and Sale and the Closing statement related to the 2006 Third-Party Sale. In addition, we performed tests on various revenues and expenses

[14] OnQ is a web-based property management system for all Hilton-affiliated hotels. It can take reservations, check room portfolios, and generate guest bills. The Hotel integrates multiple systems, including Micros, onto OnQ to track major hotel operations. Delphi is a stand-alone system for banquet services. At the end of each event, the charge will be entered into Micros and then interfaced onto OnQ.

accounts to ascertain the accuracy of the reported Adjusted Gross Revenues for the Percentage Rent calculation, as discussed below.

To determine whether Sunstone properly reported its room revenue, we recalculated the "HHonors" rewards room reimbursement for December 30, 2011, to identify any unreported revenues. To determine whether Sunstone accurately billed its guests for internet and parking services, we compared the service providers' daily reports for December 31, 2011, with Sunstone's guest records to identify any unbilled charges.

To determine whether Sunstone properly reported its F&B revenue, we judgmentally selected for review the restaurant, bar, and room service transactions processed from December 30, 2011, through January 5, 2012. Specifically, we reviewed the sequences of the guest checks generated from six Micros terminals to identify any missing checks or unreported revenues. We also interviewed the F&B Director and reviewed the union agreement to determine the staffing structure of those F&B employees. We then assessed whether the staffing for the week December 30, 2011, through January 5, 2012, was in line with the guidelines and determined whether there were any unaccounted work hours that could be related to any unreported F&B activities. We judgmentally selected to review "HHonors" free breakfasts transactions for December 31, 2011. For those transactions, we verified that "HHonors" free breakfasts were provided only to eligible guests by reviewing redeemed breakfast coupons and HHonors Checkouts Reports.

To determine whether Sunstone properly recorded and reported its banquet events revenue, we judgmentally sampled 50 event holders' folders for 2012. We traced from each banquet event order to the banquet check, and then to the Micros check to ensure that the banquet revenue was accurately and completely recorded in Micros. In addition, we judgmentally selected for review the banquet revenue of December 2012, the month with the highest banquet gratuity pay in 2012. We traced each gratuity pay to Delphi's banquet event orders and to the Event Summary Report to identify any unreported events and revenues.

To determine whether Sunstone properly deducted expenses from its Gross Revenues, we judgmentally sampled major expenses for our review. For personnel services expenses, we judgmentally reviewed the personnel files and payroll records of non-union employees for the pay periods covering December 31, 2011, and 2012. Specifically, we verified their pay rates with the approved Personnel Action Forms on file. We also checked whether Sunstone deducted non-union employee pension and health benefits for only eligible employees. We also compared non-union employees' W2 forms with the ADP Master Controls for 2011 and 2012 for consistency. To determine the appropriateness of the pay raise to unionized employees, we judgmentally selected the payroll of the restaurant servers and engineering employees to compare with the pay rates and wage increases listed in their respective union agreements for 2011 and 2012. Additionally, we verified the pay hours of the engineering employees with their timekeeping records and compared the room attendants on the union dues list and payroll records for the pay periods covering December 31, 2011, and 2012.

To determine whether Sunstone properly calculated and paid its franchise fees and franchise assessments, we reviewed the terms and provisions of the franchise agreement and related documents. We recalculated those charges for April through December 2011 and compared our recalculations with the amounts billed by Hilton Hotels Corporation to identify any discrepancies. For the property tax expenses, we determined the appropriateness of the recapture deduction in reference to Section 3.05 of the Lease. To determine whether Sunstone properly deducted the air base rents and project support payments, we reviewed the Air Lease with the New 42nd Street, Inc. To determine whether Sunstone properly deducted the lobby easement, we verified the amount claimed to the provisions under the Declaration of Easement and Operating Agreement. In addition, we reviewed the purchase price allocation to ascertain the appropriateness of the amortization of easement deduction. We also reviewed the Lease to determine the accuracy of the easement expense. To determine whether Sunstone properly deducted the hotel management fees, we verified the accuracy of the management fees to the management company, Highgate, for April through December 2011 with the management agreement. For the rest of the expense accounts, we identified FF&E-related expenses based on the account names and the descriptions and nature of the recorded transactions. We also judgmentally selected all the transactions for review from the accounts identified as Extraordinary Item and Information Systems-Franchise Fee in the trial balance.

To determine whether Sunstone properly maintained its FF&E Replacement Reserve account, we reviewed the deposit statements from February 28, 2006, through July 16, 2013, to ascertain whether Sunstone made or maintained FF&E contributions as required. In addition, we assessed whether the fund contributions and disbursements during the period were legitimate and well supported in accordance with the Lease. We also judgmentally sampled the disbursements to the three largest vendors from the 2011 FF&E Utilization Report for our review. We reviewed the vendors' contracts and invoices and determined whether the work performed qualified as FF&E expenditures in accordance with the Lease.

To determine whether Sunstone properly paid its water and sewer charges, we reviewed the Water Board's transaction history and Sunstone's payment records. To determine whether Sunstone properly reported its hotel occupancy tax and BID assessments, we reviewed the payment records and verified with the New York City Department of Finance's website to ascertain any outstanding tax payments.

To determine whether Sunstone complied with the insurance requirements of the Lease, we reviewed the insurance certificates and verified whether the coverage was adequate. We also reviewed the hotel industry reports for December 2011 and 2012 to determine whether Highgate met the performance requirements as stipulated in Section 13.10(b) of the Lease.

To determine whether EDC adequately monitored Sunstone's compliance with the Lease terms, we interviewed EDC officials regarding their Lease administration roles and requested and reviewed audit reports and follow-up action on audit-identified issues.

The results of the above tests, in conjunction with our other audit procedures, while not projected to the respective populations from which the samples were drawn, provided a reasonable basis to satisfy our audit objectives.

APPENDIX I

Sunstone Reported Occupancy, Revenues, and Expenses, and Rents Paid CY 2008 through CY 2012

	2008	2009	2010	2011	2012
Occupancy	89.7%	85.8%	88.0%	94.0%	98.0%
Gross Revenue	$58,080,507	$42,966,470	$46,817,978	$51,781,380	$54,623,034
Operating Expenses	$38,879,658	$34,403,669	$36,760,210	$39,622,141	$41,137,776
Adjusted Gross Revenue	$19,200,849	$ 8,562,801	$10,057,768	$12,159,239	$13,485,258
Base Rent	**$ 586,466**	**$ 604,059**	**$ 700,260***	**$ 663,138**	**$ 683,032**
Specified Minimum Percentage Rent	$ 741,959	$ 824,950	$ 910,430	$ 998,475	$ 1,089,162
Formula Percentage Rent	($ 600,312)	($ 2,515,161)	($ 2,246,067)	($ 1,843,269)	($ 1,604,586)
Percentage Rent	**$ 741,959**	**$ 824,950**	**$ 910,430**	**$ 998,475**	**$ 1,089,162**
Total Rent Paid	**$ 1,328,425**	**$ 1,429,009**	**$ 1,610,690**	**$ 1,661,613**	**$ 1,772,194**

* The 2010 Base Rent figure of $700,260 includes prior year assessments and penalties for Calendar Years 2007 through 2010.

APPENDIX II

Comparative 2011 ATHPC and Formula Percentage Rent Calculations*

Description	Per Sunstone (A)	Per Auditors (B)	Potential or Actual Overstatement/ (Understatement) (A - B)
ATHPC Calculation			
ITHPC + 50% (Gross consideration - ITHPC)			
ITHPC	$113,330,262	$73,665,000	$39,665,262**
Gross consideration	240,347,999	240,347,999	
Less: ITHPC	113,330,262	73,665,000	
	$127,017,737	$166,682,999	
x 50%	50%	50%	
50% (Gross consideration - ITHPC)	$63,508,869	$83,341,500	
ATHPC	**176,839,131**	**157,006,500**	**19,832,631**
AGR	**12,159,239**	**13,183,863**	**(1,024,624)**
Formula Percentage Rent Calculation			
14% ATHPC	**24,757,478**	**21,980,910**	
12% ATHPC	**21,220,696**	**18,840,780**	
Formula Percentage Rent Calculation - Part I			
12% [(The < of: AGR or 14% ATHPC) – 12% ATHPC]			
The < of: **AGR** or 14% ATHPC	12,159,239	13,183,863	
Less: 12% ATHPC	21,220,696	18,840,780	
	$(9,061,457)	$(5,656,917)	
x 12%	12%	12%	
	$(1,087,375)	$(678,830)	
Formula Percentage Rent Calculation - Part II			
18% (AGR – 14% ATHPC)			
AGR	12,159,239	13,183,863	
Less: 14% ATHPC	24,757,478	21,980,910	
	$(12,598,239)	$(8,797,047)	
x 18%	18%	18%	
	$(2,267,683)	$(1,583,468)	
Formula Percentage Rent	**$(3,355,058)**	**$(2,262,298)**	**$(1,092,760)**
Specified Minimum Amount	**$998,475**	**$998,475**	

* We applied the Formula Percentage Rent methodology determined by auditors. As noted, this formula is expressed as: 12% [(The < of: AGR or 14% ATHPC) – 12% ATHPC] + 18% (AGR – 14% ATHPC).

** Unsubstantiated ITHPC (i.e., claimed ITHPC of $113.3 million less the initial construction mortgage amount of $73.7 million)

APPENDIX III

Comparative 2011 Formula Percentage Rent Methodologies and Calculations

Description	Per Sunstone (A)	Per Auditors (B)	Potential or Actual Overstatement / (Understatement) (A - B)
ATHPC Calculation			
ITHPC + 50% (Gross consideration - ITHPC)			
ITHPC	$73,665,000	$73,665,000	
Gross consideration	240,347,999	240,347,999	
Less: ITHPC	73,665,000	73,665,000	
	$166,682,999	$166,682,999	
x 50%	50%	50%	
50% (Gross consideration - ITHPC)	$83,341,500	$83,341,500	
ATHPC	**157,006,500**	**157,006,500**	
AGR	**13,183,863**	**13,183,863**	
Formula Percentage Rent Calculation			
14% ATHPC	**21,980,910**	**21,980,910**	
12% ATHPC	**18,840,780**	**18,840,780**	
2% ATHPC	**3,140,130**	**3,140,130**	
Formula Percentage Rent Calculation - Part I (Per Auditor)			
12% [(The < of: AGR or 14% ATHPC) – 12% ATHPC]			
The < of: **AGR** or 14% ATHPC		13,183,863	
Less: 12% ATHPC		18,840,780	
Formula Percentage Rent Calculation - Part I (Per Sunstone)			
12% [The < of: AGR or (14% ATHPC – 12% ATHPC)]			
The < of: AGR or 2% ATHPC	3,140,130		
	$3,140,130	$(5,656,917)	
x 12%	12%	12%	
	$376,816	$(678,830)	
Formula Percentage Rent Calculation - Part II			
18% (AGR – 14% ATHPC)			
AGR	13,183,863	13,183,863	
Less: 14% ATHPC	21,980,910	21,980,910	
	$(8,797,047)	$(8,797,047)	
x 18%	18%	18%	
	$(1,583,468)	$(1,583,468)	
Formula Percentage Rent	**$(1,206,652)**	**$(2,262,298)**	**$1,055,646**
Specified Minimum Amount	**$998,475**	**$998,475**	

* We applied ITHPC, gross consideration, ATHPC, and AGR as determined by auditors.

SUNSTONE
HOTEL INVESTORS

November 13, 2014

Marjorie Landa, Deputy Comptroller
City of New York
Office of the Comptroller
1 Centre Street, Room 1100
New York, New York 10007

VIA FEDEX OVERNIGHT

Re: Response to Your Letter dated October 29, 2014

Dear Ms. Landa:

We are in receipt of your letter dated October 29, 2014 ("Your Letter"), concerning compliance of Sunstone 42nd Street, LLC ("Sunstone") and New York City Economic Development Corporation (the "EDC") under the Agreement of Lease, dated November 5, 1998 (as amended and assigned, the "Lease"). We understand that the EDC administers the Lease on behalf of the City of New York ("Landlord"), and at all times relevant to the matters set forth in Your Letter the EDC was duly authorized by Landlord to make decisions concerning, among other things, Sunstone's compliance with its obligations under the Lease.

In response to Your Letter, we address below each of the recommendations set forth in the draft audit report enclosed with Your Letter.

Recommendation Number 1 – When calculating ATHPC, and in turn the Formula Percentage Rent, use ITHPC as stipulated by the development budget last approved by the construction lender prior to or in connection with closing the Construction Loan.

Sunstone Response to Recommendation Number 1 – Sunstone's predecessor-in-interest under the Lease is FC 42 Hotel, LLC (hereinafter, "FC"). FC constructed the Hotel pursuant to the Lease, and the Hotel opened for business in May 2000. FC's fiscal year, at the time in question, began on February 1 and ended January 31. For the fiscal year ended January 31, 2001, FC presented audited financial statements, which reflect "total assets" of $113,330,682.[1] Not coincidentally, the "total assets" value set forth in FC's audited financial statements for its fiscal year ended January 31, 2001 (i.e.,

[1] See Exhibit A.

SUNSTONE
HOTEL INVESTORS

$113,330,682) is within $500 of the "sample" development budget value of $113,330,262 set forth in the Lease.[2]

Sunstone is not privy to information previously provided by FC to the EDC or Landlord, so we cannot comment on the previously disclosed/discussed information between FC and the EDC/Landlord. Of the presently available information, the audited financial statements of FC (especially when coupled with the "sample" development budget value) are the most reliable data for determining the development budget for construction of the Hotel. We know that the initial November 13, 1998 construction mortgage amount was $73.7 million, the "sample" development budget dated November 3, 1998 was $113.3 million, and that FC's financial records reflected "total assets" of $113.3 million as of January 31, 2001. Accordingly, we know that the initial construction mortgage amount of $73.7 million divided by $113.3 million represents a 65% loan-to-construction budget, which seems like a very fair representation of construction lending practices at the time in question.

Sunstone asserts that, when calculating Percentage Rent under the Lease, the value to be used for "Total Project Cost" should be either $113,330,682 or $113,330,262.

Recommendation Number 2. When calculating AGR, and in turn the Formula Percentage Rent, deduct Operating Expenses as stipulated and limited by the Lease.

Sunstone Response to Recommendation Number 2 – Sunstone will continue to deduct Operating Expenses pursuant to the terms of the Lease when determining Percentage Rent. Note, the draft audit report expressly states that NO additional Percentage Rent is due Landlord as a result of any previous incorrect calculation of AGR.

Recommendation Number 3. Properly calculate the Formula Percentage Rent.

Sunstone Response to Recommendation Number 3 – Sunstone correctly calculated Percentage Rent in accordance with "Example of Calculation of Percentage Rent", as set forth in Exhibit A[3] of the Lease; however, Sunstone is amenable to having the Lease amended to reflect the Percentage Rent formula purported to be the "proper" formula in the draft audit report and as suggested by the EDC. Accordingly, Sunstone requests that Exhibit A of the Lease be amended to finally resolve any ambiguities between the formula language and the Lease exhibit.

---

[2] See Exhibit B.
[3] See Exhibit C.

120 Vantis, Suite 350
Aliso Viejo, CA 92656
www.sunstonehotels.com

SUNSTONE
HOTEL INVESTORS

<u>Recommendation Numbers 4 and 5</u>. Replenish \$4,424,615 to the FF&E reserve account (\$3,093,862 for contributions that were not made or maintained, \$908,721 for interest, and \$422,032 for improper disbursements). Make and maintain FF&E contributions as required by the Lease.

Sunstone Response to Recommendation Numbers 4 and 5 – Sunstone acquired FC's interests under the Lease in March 2006. The Lease requires Sunstone to, among other things, make all necessary repairs, restorations and replacements to the Hotel. To this end, Sunstone has invested substantial amounts of capital into the Hotel, above and beyond the requirements of the Lease. Below are certain data points that clearly delineate and support Sunstone's positions that (a) Sunstone, contrary to the assertion in the draft audit report, has continuously contributed at least three percent (3%) of gross revenues into the FF&E reserve account, and (b) Sunstone does not owe additional monies to the FF&E reserve account.

*\$447,500,396 = gross revenues at the Hotel from March 2006 through September 30, 2014 (the "Period").[4]

*\$15,555,456 = three percent (3%) of the Hotel's gross revenues for the Period, comprised of \$13,425,012 plus the initial contribution from FC of \$2,130,444 per the draft audit report.[5]

*\$18,173,125 = Sunstone's actual contribution into the FF&E reserve account for the Period.[6]

*\$34,372,430 = Sunstone's investments into the Hotel for the Period, of which \$31,131,351 are qualified FF&E expenses under the Lease.

As set forth above, the FF&E reserve account has been overfunded for the Period, leaving a credit balance in favor of Sunstone in the amount of \$2,617,669. Accordingly, Sunstone disagrees with the findings in the draft audit report that Sunstone is required to deposit additional funds into the FF&E reserve account. Furthermore, even assuming that Sunstone were required to contribute to the FF&E reserve account an additional \$963,418 received from its 2010 loan refinancing, \$908,721 for interest and \$422,032 for improper disbursements, there would still be a credit balance of \$323,498 in favor of Sunstone. Moreover and lastly, while not directly on point to the issue of over contribution to the FF&E reserve account, Sunstone's dedication to properly maintaining the Hotel is apparent in that Sunstone has invested more than \$30.0 million into the Hotel

[4] See Exhibit D.
[5] See Exhibit D.
[6] See Exhibit D.

SUNSTONE
HOTEL INVESTORS

during the Period, which is more than twice the amount required to have been deposited into the FF&E reserve account.

Recommendation Number 6. Use FF&E reserve account funds only for FF&E qualifying expenses as stipulated by the Lease.

Sunstone Response to Recommendation Number 6 – Sunstone will continue to use FF&E reserve account funds pursuant to the terms of the Lease.

Recommendation Number 7. Maintain documentation evidencing how FF&E funds are used as required by the Lease.

Sunstone Response to Recommendation Number 7 – Contrary to the assertion in the draft audit report, Sunstone has provided either or both the EDC and Landlord with FF&E utilization reports for years 2006 through 2013.[7] Sunstone will continue to provide EDC with FF&E utilization reports as required by the Lease.

Furthermore, in order to standardize the reporting process, Sunstone and the EDC must reach an agreement as to (a) the identity/ies of the EDC recipients for the FF&E utilization reports required under the Lease, (b) the mode for delivery (i.e., email, FedEx, etc.) and (c) the form of reports (i.e., confirmation of whether Exhibit E hereto is acceptable).

Recommendation Number 8. Submit to EDC, in the manner and time frames specified by the Lease, required financial and operating reports including but not limited to: annual audited property-level financial statements; monthly STR reports comparing Hilton's performance to that of the Competitive Set regarding occupancy, average room rate, and other data; property inspection reports; and certified FF&E reserve account depository statements, and budgeted and actual utilization reports with explanations of variances.

Sunstone Response to Recommendation Number 8 – Sunstone believes that it is currently complying with the reporting requirements of the Lease. In respect to Section 17.01 (c) of the Lease, Sunstone has provided the EDC with annual consolidated financial statements, audited by Ernst & Young, which includes Sunstone as required by the Lease. The Lease does not specify that property-level financial statements are required. However, Sunstone is amenable to providing the EDC with audited property-level financial statements for Sunstone's fiscal year ending December 31, 2014 and forward. To that end, we request the EDC to confirm that (a) audited property-level

[7] Exhibit E.

SUNSTONE
HOTEL INVESTORS

financial statements for years 2014 and forward will be acceptable, and (b) the EDC is NOT seeking to have audits of financial statements for prior years.

Sunstone will continue to provide the EDC with monthly STR reports as required by the Lease. In addition, Sunstone will continue to provide the EDC with FF&E reserve account depository statements, FF&E budget reports and actual FF&E utilization reports, all as required by the Lease. We request the EDC to confirm that the reports attached hereto as Exhibit E and Exhibit F are acceptable in so far as Sunstone is obligated to provide FF&E utilization and budget reports, respectively. We also request the EDC to confirm (a) the identity/ies of the EDC recipients for the aforementioned periodic reports and (b) the mode for delivery (i.e., email, FedEx, etc.).

The above information is not meant to, and shall not be construed as, Sunstone having waived any of its rights under the Lease. Specifically, Sunstone reserves the right to exercise any rights under the Lease, including exercising defenses of laches, estoppel and waiver to any action by Landlord or the EDC under the Lease.

Thank you for your prompt attention to this matter. We sincerely look forward to continuing our relationship with both the EDC and City of New York.

Sincerely,

Alan Childree
(949) 382-3062

cc: Spencer E. Hobson, PA, CIA • Finance Director
New York City Economic Development Corporation
110 William Street
New York, New York 10038

SUNSTONE
HOTEL INVESTORS

Exhibit A

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
1500 One Cleveland Center
1375 East Ninth Street
Cleveland OH 44114-1700
Telephone (216) 875 3000
Facsimile (216) 575 0170

REPORT OF INDEPENDENT ACCOUNTANTS

To the Members of
FC 42 Hotel, LLC

In our opinion, the accompanying balance sheet and the related statements of operations, changes in members' equity, and cash flows present fairly, in all material respects, the financial position of FC 42 Hotel, LLC (a New York Limited Liability Company) (the "Company") at January 31, 2001 and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

PricewaterhouseCoopers LLP

September 26, 2001

FC 42 HOTEL, LLC
(A New York Limited Liability Company)
BALANCE SHEET
January 31, 2001

ASSETS

PROPERTY AND EQUIPMENT	
Building and building equipment	$ 104,727,593
Furniture, fixtures and equipment	8,603,089
	113,330,682
Less accumulated depreciation	2,008,673
	111,322,009
DEFERRED COSTS	
Mortgage procurement costs-net of accumulated amortization of $199,574	2,341,218
OTHER ASSETS	
Cash	6,647,790
Restricted cash	1,771,046
Accounts receivable, net of allowance for doubtful accounts of $51,185	1,642,696
Accounts receivable, affliate	340,058
Prepaid expenses	2,840,692
Other assets	415,420
	13,657,702
	$ 127,320,929

LIABILITIES AND MEMBERS' EQUITY

LOANS PAYABLE	
Mortgage loan payable	$ 83,600,000
Affiliate loan	15,000,000
	98,600,000
OTHER LIABILITIES	
Accounts payable and accrued expenses	5,698,303
Accounts payable, affiliate	1,542,205
Construction payable	5,510,779
Accrued interest	266,667
	13,017,954
MEMBERS' EQUITY	15,702,975
	$ 127,320,929

The accompanying notes are an integral part of these financial statements.

SUNSTONE
HOTEL INVESTORS

Exhibit B

the use of the Property and New 42 Hotel Property, the transactions contemplated hereunder or any documents to which Tenant is a party, creating or transferring an interest or estate in the Property and New 42 Hotel Property, or (e) any occupancy, use or possession of the Property and New 42 Hotel Property, or any part thereof, the appurtenances thereto or the sidewalks, streets, alleys or vaults adjacent thereto; but shall not include any PILOT, Full Taxes, payments in respect of Sales Tax Savings, municipal, state or federal income taxes assessed against Landlord or Tenant, capital levy, estate, gift, succession, inheritance or transfer taxes imposed on or assessed against Landlord, or any corporate franchise taxes or unincorporated business taxes imposed upon any owner of the Land, or any part thereof, or any income, profits or revenues tax, assessment or charge imposed upon the Rent received as such by Landlord under this Lease ("***Excluded Taxes***"); provided, however, that if at any time during the term of this Lease the present method of taxation or assessment shall be so changed that any Excluded Taxes shall either be added to, or substituted in whole or in part for, Impositions, then any such Excluded Tax shall, to the extent that it is so substituted, be deemed to be included within the term "***Impositions***".

The term "***Improvements***" shall mean any buildings and structures, and any building machinery, equipment and fixtures (including Equipment) affixed to and forming a part of the buildings and structures, which may be erected or located wholly or partially on the Land during the term of this Lease by or on behalf of Tenant.

The term "***Initial Total Hotel Project Cost***" shall mean the estimated cost of completing the Construction Work and preparing the Hotel Project for opening, as set forth in the development budget last approved by Tenant's construction lender prior to or in connection with closing the Construction Loan, the form of which development budget is attached hereto as Schedule P; provided, however, if any of the costs and expenses included in such development budget are payable to a Related Entity of Tenant or to an employee of such a Related Entity, the line item in such development budget for such costs and expenses shall not exceed customary amounts (it being agreed, for such purposes, that a development fee/distribution not to exceed three percent (3%) of Initial Total Hotel Project Costs (excluding therefrom the amount of the development fee/distribution) payable to a Related Entity of Tenant is customary).

The term "***Insurance Requirements***" shall mean all of the terms and conditions of all insurance policies covering, related to or applicable to the Hotel Project, all requirements of the issuers of such policies and all rules, regulations, orders and other requirements or standards issued, promulgated or recommended by the National or Regional Board of Fire Underwriters, the National or Regional Fire Protective Association or any other national or regional body exercising similar functions whose requirements or standards must be complied with in order to obtain any governmental approval or insurance policy required hereunder, and applicable to or affecting the Hotel Project or the use and occupancy thereof.

	42ND STREET - HOTEL BUDGET	
		Total Budget
	HARD COSTS	as of 11/3/98
1	Base Building Upgrade	8,965,695
2	Building Trades	50,229,776
3	General Conditions/CM Fee	5,000,000
4	Pre-Construction Services	100,000
5	Permits	152,500
6	Bonds	1,155,033
7	Construction Contingency	5,957,916
8	FF & E	10,120,000
	HARD COSTS TOTAL	**81,680,920**
	SOFT COSTS	
9	Architectural & Engineering	2,600,000
10	Hotel Consulting/Commissions	1,900,000
11	Legal	1,600,000
12	Construction Interest	3,437,700
13	Interest On Promus Financing	1,250,000
14	Financing Fees & Out-of-Pocket	4,465,614
15	Mortgage Recording Tax	2,025,788
16	Title Fee	430,000
17	Bank Inspection	46,500
18	Owner's Testing/Survey	400,000
19	Site Management	5,644,796
20	Pre-Opening / Working Capital	3,000,000
21	Public Party Payment	750,000
22	Project Expenses / Other Consultants	600,000
23	Marketing	500,000
24	Property Management	300,000
25	Insurance	100,000
26	Transfer Tax	49,204
27	Development Contingency	1,297,541
28	Development Costs	1,252,199
	SOFT COSTS TOTAL	**31,649,342**
	TOTAL PROJECT COSTS	**113,330,262**

SUNSTONE
HOTEL INVESTORS

Exhibit C

120 Vantis, Suite 350
Aliso Viejo, CA 92656
www.sunstonehotels.com

EXHIBIT A

Example of Calculation of Percentage Rent

Based on Theoretical 1st Full Stabilized Year of Operation

ASSUMPTIONS

1	Total Project Cost ("TPC")			$ 83,000,000
2	Gross Revenues			26,000,000
3	Base Ground Rent, PILOT, Easement Payments			1,150,000
4	Qualified Expenses			10,000,000
5	Adjusted Gross Revenues ("AGR") Gross Revenues less #3 and #4			14,850,000

PARTICIPATION RENT FORMULA

1	Tier I of LL sharing in AGR: 12% of AGR over 12% of total project cost and below 14% of total project cost		$ 11,620,000	14% of TPC
		(Less)	9,960,000	12% of TPC
			1,660,000	
			x12%	
			199,200	Paid in LL
2	Tier 2 of LL sharing in AGR: 18% of AGR over 14% of total project cost		14,850,000	Total AGR
		(Less)	11,620,000	14% of TPC
			3,230,000	
			x18%	
			581,400	
			780,600	Total Paid to LL

Note: This example is for illustration purposes only. The above figures are merely examples and do not reflect actual numbers/percentages for the project.

SUNSTONE
HOTEL INVESTORS

Exhibit D

FF&E Reserve Contribution & Capital Expenditure Analysis

Hilton Times Square

REQUIRED CONTRIBUTIONS

	03/17/06 - 12/31/06	2007	2008	2009	2010	2011	2012	2013	01/01/14 - 09/30/14	TOTAL
Total Gross Revenue	43,354,053	56,447,420	58,080,505	42,966,470	46,817,975	51,781,382	54,623,034	52,509,244	40,920,313	
Beginning FF&E Replacement Reserve	-	3,431,065	5,124,488	6,866,903	8,155,897	9,560,436	11,113,878	12,752,569	14,327,846	
Carryover Balance from Prior Ownership	2,130,444	-	-	-	-	-	-	-	-	2,130,444
+3% FF&E Contribution	1,300,622	1,693,423	1,742,415	1,288,994	1,404,539	1,553,441	1,638,691	1,575,277	1,227,609	13,425,012
Ending FF&E Replacement Reserve	3,431,065	5,124,488	6,866,903	8,155,897	9,560,436	11,113,878	12,752,569	14,327,846	15,555,456	15,555,456

ACTUAL CONTRIBUTIONS

	03/17/06 - 12/31/06	2007	2008	2009	2010	2011	2012	2013	01/01/14 - 09/30/14	TOTAL
Total Gross Revenue	43,354,053	56,447,420	58,080,505	42,966,470	46,817,975	51,781,382	54,623,034	52,509,244	40,920,313	
Beginning FF&E Replacement Reserve	-	1,513,541	3,164,621	4,815,701	6,466,781	10,650,472	12,577,729	14,504,986	16,432,243	
Carryover Balance from Loan Assumption	275,231	-	-	-	-	-	-	-	-	275,231
Refinancing - Prior Loan	-	-	-	-	(963,418)	-	-	-	-	(963,418)
Refinancing - New Loan	-	-	-	-	3,450,000	-	-	-	-	3,450,000
Actual FF&E Contribution	1,238,310	1,651,080	1,651,080	1,651,080	1,697,110	1,927,257	1,927,257	1,927,257	1,740,882	15,411,313
Ending FF&E Replacement Reserves	1,513,541	3,164,621	4,815,701	6,466,781	10,650,472	12,577,729	14,504,986	16,432,243	18,173,125	18,173,125

CAPITAL EXPENDITURES

	03/17/06 - 12/31/06	2007	2008	2009	2010	2011	2012	2013	01/01/14 - 03/31/14	TOTAL
FF&E Qualifying Expenses	1,248,845	5,690,224	2,125,444	704,255	122,065	2,093,417	8,629,674	10,393,623	123,803	31,131,351
FF&E Non-qualifying Expenses	76,334	233,192	734,413	334,096	326,865	454,040	316,153	680,515	85,471	3,241,079
Total Capital Expenditures	1,325,179	5,923,416	2,859,856	1,038,351	448,929	2,547,458	8,945,828	11,074,138	209,274	34,372,430

SUNSTONE
HOTEL INVESTORS

Exhibit E

Historical CapX

New York Hilton Times Square

as of January, 2014

Cat#		2006	2007	2008	2009	2010	2011	2012	2013	Total Paid
02	Technical Fees	171,665	316,937	109,390	86,958	75,625	361,235	354,111	216,790	1,692,711
03	Guestrooms	774,110	1,551,176	393,623	36,341	0	278,627	5,925,515	4,316,260	13,275,651
04	Suites	5,000	2,115,636	12,007	0	0	0	11,134	140,018	2,283,795
05	Guestroom Baths	124,985	1,322,456	0	0	0	0	342,701	3,998,363	5,788,504
06	Corridors	0	57,647	73,790	40,700	0	1,500	178,889	548,392	900,918
07	Lobby	37,341	39,649	849,003	86,320	0	995,983	1,062,967	825,704	3,896,966
08	Public Restrooms	0	0	178,338	305,485	0	0	0	0	483,823
09	Meeting Rooms	0	126,184	433,439	19,439	0	0	55,176	0	634,238
10	Recreation/Entertainment	0	86,395	49,427	850	0	0	0	0	136,672
11	Restaurant/Lounge/Banquet/Catering	26,726	9,287	94,186	32,826	0	6,880	23,775	184,454	378,133
12	Building Systems/Back of House	163,120	80,050	86,264	117,586	101,014	76,805	3,489	172,863	801,192
13	Exterior Building	0	217,999	406,242	147,528	248,450	646,198	647,326	572,473	2,886,216
14	Technology/Preopening/Conversion	22,232	0	71,075	69,710	293	82,306	228,099	1,581	475,296
15	Miscellaneous	0	0	0	0	0	0	38,956	34,453	73,409
16	Business Center	0	0	0	0	0	4,843	0	0	4,843
20	Hotel Discretionary	0	0	103,073	94,608	23,547	93,081	73,689	62,788	450,787
	Total Property Cash Flow	**1,325,179**	**5,923,416**	**2,859,856**	**1,038,351**	**448,929**	**2,547,458**	**8,945,828**	**11,074,138**	**34,163,155**

Major Scope Completed

2006/2007

- New guestroom carpet, lounge and desk chairs, window treatments, in room coffee makers
- Guest corridors - corridor vinyl wall covering, tile at vending areas & stairwell paint
- Renovation of Guest baths - mirrors, vinyl wall covering, shower curtains & rods
- Conversion of 16 two room suites to 32 new standard guestrooms
- Lobby / Lounge / Restaurant Reconfiguration to include replacement of FF&E
- Health Club relocation from 23rd floor to the 16th floor with new finishes and equipment
- Soft renovation inclusive of carpet & paint in meeting space
- Installation of new beds in all guestrooms
- New guestroom LCD TVs & dressers

2008

- Sky Lobby-15th Floor renovation
- 16th Fl Mtg Sp Renovation
- ADA upgrades to public bathrooms
- Interior Lower Lobby Renovation including motor lodge
- Guestroom Granite & LCD TVs
- Corridor FF&E
- Restaurant FF&E
- Micros POS upgrade

2009

- Installation of Hypo-allergenic air purification system ("Pure")
- Public Bathroom ADA renovation on CC level
- Kitchen Hood Exhaust System & Hot Water Boiler Controls installed for energy savings
- Building System projects such as VFDs, Hot Water Tank and Heat Exchanger Gaskets
- Catwalk for access to towers
- Copiers

2010

- Design for Guestroom, Bathroom & Corridor Renovation
- Replacement of Grease Trap
- Building Exterior Maintenance including exterior skin (EFIS) and painting steel roof

2011

- Conversion of Doubles to Queen Rooms
- 45th Floor Roof Replacement (begun in 2010)
- Metal Panel Curtain Wall Replacement (begun in 2010)
- Commencement of Lower Lobby & Exterior (incl Signage) Renovation
- Emergency Façade Repairs
- Security Equipment

2012

- Guestroom Renovation commenced including Rooms, Presidential Suite, Bathrooms & Corridors
- 1st Floor Lobby, Motor Lodge & Exterior Renovation including Exterior Signage (begun in 2011)
- Banquet Chairs
- Painted Steel Roof Beam Replacement
- Guest HSIA
- Guest Elevator Cab Interior Renovation commenced (to be complete in 2013)
- Radios for Digital Equipment
- Security Equipment
- Housekeeping Equipment including room attendant carts & vacuums

2013

- Guestroom Renovation completed including Rooms, Presidential Suite, Bathrooms & Corridors
- Lobby, Lobby Bar & Restaurant Renovation
- Kitchen Equipment
- Guest Elevator Cab Interior Renovation completion
- 23rd Floor Roof Replacement
- Façade Consultants
- Locker Room Upgrades
- Heat Exchange & Cooling Tower Heat Tracer
- Building Management System Upgrades

SUNSTONE
HOTEL INVESTORS

Exhibit F

Sunstone Hotel Partnership, LLC
2015 FF&E Replacement & Capital Repairs Budget

Property:	Hilton Times Square - HT0
Location:	
City:	New York
State:	NY
TTL Rooms:	460
TTL GR Floors:	22

					A	B	C = A x B	
Job #	Cost Code	Category	Project Name	Scope Description (Including Comments)	Qty	Unit Cost	Total	Funding Type
428-15-03	428-21-140	02 Technical Fees	PIP	Design - Meeting Space	1	40,000	40,000	Capital Repairs
428-15-02	428-21-100	02 Technical Fees	Building	Local Law 11 - Architectural fees for meeting local law.	1	10,000	10,000	Capital Repairs
		Technical Fees Total					**50,000**	
428-15-02	428-16-870	03 Guestrooms	HVAC Motors	Purchase of motors as backup for the HVAC units in the guest rooms as they burn out	65	288	18,649	Capital Repairs
		Guestrooms Total					**18,649**	
428-15-04	428-08-300	05 Guestroom Baths	Barn Door hardware	Guest Bathroom Barn Door parts	1	160,000	160,000	FF&E Repl
		Guestroom Baths Total					**160,000**	
428-15-04	428-12-100	06 Corridors	Art		1	10,000	10,000	FF&E Repl
		Corridors Total					**10,000**	
428-15-04	428-12-001	07 Lobby	Lobby FF&E Refresh	Lobby décor - Replenish product in area.	1	20,000	20,000	FF&E Repl
		Lobby Total					**20,000**	
428-15-04	428-09-510	09 Meeting Rooms	CC Level Foyer Molding	includes repairs to ceiling molding, plaster and paint. (North side of CC Level.)	1	10,000	10,000	FF&E Repl
428-15-04	428-12-605	09 Meeting Rooms	Tables	Replace task tables	60	646	38,760	FF&E Repl
		Meeting Rooms Total					**48,760**	
428-15-04	428-11-400	11 Restaurant/Kitchen/Bar	Cold Buffet Station	Cold buffet station - take chiller plate off and replace with a different unit.	1	20,000	20,000	FF&E Repl
428-15-04	428-11-425	11 Restaurant/Kitchen/Bar	Kitchen Equipment	*Slicing machine *Charbroiler *Deep fryer *Espresso Machine	1	35,000	35,000	FF&E Repl
428-15-04	428-11-400	11 Restaurant/Kitchen/Bar	Buffet equipment	Buffet equipment - new risers, & props for banquet tables	1	10,589	10,589	FF&E Repl
		Restaurant/Kitchen/Bar Total					**65,589**	

Sunstone Hotel Partnership, LLC
2015 FF&E Replacement & Capital Repairs Budget

Property: Hilton Times Square - HT0
Location:
City: New York
State: NY
TTL Rooms: 460
TTL GR Floors: 22

Job #	Cost Code	Category	Project Name	Scope Description (Including Comments)	A Qty	B Unit Cost	C = A x B Total	Funding Type
428-15-02	428-15-710	12 Back of House Systems	Heat Exchangers	Rehab	1	50,000	50,000	Capital Repairs
428-15-02	428-15-680	12 Back of House Systems	Chiller	Overhaul Chiller 1	1	49,675	49,675	Capital Repairs
428-15-02	428-15-500	12 Back of House Systems	Toilet Exhaust Fans, LL87	Replace 17 toilet exhaust fans	1	29,365	29,365	Capital Repairs
428-15-02	428-15-220	12 Back of House Systems	Chilled Water Pumps, LL87	Retro commissioning	3	6,667	20,000	Capital Repairs
428-15-02	428-15-500	12 Back of House Systems	HVAC distribution balancing, LL87	Balance the air and water distribution systems. Increase ventilation rates at AHU-1,2 (AHU-1,2, AC-R-1, Base Building Condenser Water and Hot Water)	1	20,000	20,000	Capital Repairs
428-15-02	428-15-240	12 Back of House Systems	Water Reservoir/Tank	Update probes	2	5,000	10,000	Capital Repairs
428-15-02	428-15-240	12 Back of House Systems	Standpipe Fire System house tank	Rehab	1	10,000	10,000	Capital Repairs
428-15-02	428-15-500	12 Back of House Systems	ACR1	Water Pan	1	10,000	10,000	Capital Repairs
428-15-02	428-15-930	12 Back of House Systems	HVAC System Economizer controls, LL87	Repair Controls	1	7,000	7,000	Capital Repairs
428-15-02	428-15-200	12 Back of House Systems	chemical water treatment	Nalco cooling water protection program - equipment costs required related to conversion	1	6,500	6,500	Capital Repairs
428-15-02	428-15-120	12 Back of House Systems	Hot Water Mixing Valves, LL87		1	3,000	3,000	Capital Repairs
		Back of House Systems Total					**215,540**	
428-15-04	428-14-201	13 Building	Elevator Key Access	Card Access Security System - 6 Pack Passenger Elevators	1	30,495	30,495	FF&E Repl
428-15-02	428-07-200	13 Building	Pipe insulation, LL87		1	20,000	20,000	Capital Repairs

Sunstone Hotel Partnership, LLC
2015 FF&E Replacement & Capital Repairs Budget

Property: Hilton Times Square - HT0
Location:
City: New York
State: NY
TTL Rooms: 460
TTL GR Floors: 22

Job #	Cost Code	Category	Project Name	Scope Description (Including Comments)	A Qty	B Unit Cost	C = A x B Total	Funding Type
428-15-02	428-15-840	13 Building	Ductwork in Chiller Room, LL87		1	7,000	7,000	Capital Repairs
		Building Total					**57,495**	
428-15-04	428-16-766	14 Technology	Copiers	Replace 5 office copiers	5	6,400	32,000	FF&E Repl
428-15-04	428-11-900	14 Technology	Camera	Replacement Server and potentially a couple of security cameras to retire old ones.	1	22,000	22,000	FF&E Repl
428-15-02	428-11-913	14 Technology	Accubar	Accubar- Update beverage inventory system	2	1,736	3,472	Capital Repairs
428-15-04	428-16-765	14 Technology	Computers	Laptop for Director of HR/Ipad	1	2,500	2,500	FF&E Repl
428-15-04	428-16-760	14 Technology	HSIA	Replace all access points & add access points to all Meeting Space and Admin Areas	1	130,000	130,000	FF&E Repl
		Technology Total					**189,972**	
428-15-04	428-09-700	15 Miscellaneous	Bathroom tile in the employee bathroom area	Bathroom tile in the employee bathroom area - 15th Floor next to executive offices.	1	14,000	14,000	FF&E Repl
		Miscellaneous Total					**14,000**	
428-15-04	428-01-999	20 Hotel Discretionary	Hotel Discretionary	Discretionary Wish List - All projects under 20K	1	185,795	185,795	FF&E Repl
		Hotel Discretionary Total					**185,795**	
		Grand Total					**1,035,800**	

NYCEDC
New York City Economic Development Corporation

November 14, 2014

New York City Comptroller's Office
One Centre Street, Room 1100
New York, New York 10007-2341
Municipal Building
Attn: Marjorie Landa, Deputy Comptroller

Re: Response to Audit Report on Sunstone Hotel Investors, Inc.'s Compliance with Its Lease Agreement to Operate the Hilton Times Square Hotel
FK13-088A

Dear Ms. Landa:

New York City Economic Development Corporation (EDC) has reviewed the draft of the above-referenced audit report, dated October 29, 2014, and responds to the recommendations directed in the audit as follows:

On July 1, 2011, EDC took on the responsibility of managing and administering the leases and other project related agreements between the City, State and 3rd parties in connection with the 42nd Street development project. Prior to this time, management and administration was the responsibility of 42nd Street Development Project, Inc. (42DP), an entity established by the State of New York.

Shortly thereafter, EDC implemented a program to audit each lease agreement in the portfolio by an independent CPA firm to assure compliance with applicable agreements. This includes the Hilton Times Square Hotel lease between 42 DP and FC 42 Hotel LLC (FC) dated November 5, 1998 and assigned to Sunstone 42nd Street LLC ("Sunstone") on March 17, 2006 (the "Lease") which was completed by Marks Paneth LLP (MP). EDC relied upon MP to identify issues to help ensure proper lease compliance.

Recommendation # 9: Investigate and determine the proper ITHPC as stipulated by the development budget last approved by the construction lender prior to or in connection with closing the Construction Loan.

EDC's Response: A valid ITHPC has been determined. As indicated above, the Lease was entered into on November 5, 1998 (the "Date of Lease") and was managed and administered by 42 DP until July 1, 2011. Since the Date of Lease, FC and Sunstone have used $113,330,262 as the Initial Total Hotel Project Cost (ITHPC) in their calculation of Percentage Rent. This number is derived from the detailed development budget in Schedule P of the Lease dated November 3, 1998. The Lease defines ITHPC as the "estimated cost of completing the Construction Work and preparing the Hotel

Project for opening as set forth in the development budget last approved by Tenant's construction lender prior to or in connection with closing the Construction Loan..."

MP, in their lease audit, said that although Sunstone was unable to provide them with a signed final development budget, "it is possible given the November 5, 1998 date of the Lease and the November 13, 1998 date of the initial mortgage that the pro-forma document included in the lease was indeed, the final development budget approved by the lender."

On July 25, 2014, FC provided requisitions submitted to the Administrative Agent for the Building Loan Agreement in 1998 (Requisition #1) and later in 2000 (Requisition #17) which further established the approved construction budget. Both requisitions included a construction budget of $113,330,262, the same as in Schedule P of the Lease. This was forwarded to the Comptroller's Office and is attached hereto as Exhibit A as further supports the use of the $113,330,262 as the proper ITHPC.

The Comptroller's Audit Report, however, indicates that the ITHPC might be overstated and could be as low as $73,665,000. EDC does not concur with this analysis, which fails to take into account <u>all</u> the sources of funds for the project such as equity of $24,665,262 and a mezzanine loan from Hilton (Promus) of $15,000,000 as detailed in Requisition #1. In our view, it would have been highly unlikely to be able to finance a new, to be built hotel 100% with senior construction debt. Attached as Exhibit B are the sources of funds (extrapolated from Requisition #1) in a table format along with additional documentation as support which total $113,330,262.

While there may not be any document that explicitly says "lender-approved construction budget"; based on the information above, EDC and the tenants have reasonably and properly concluded that the $113,330,262 in Schedule P of the Lease, is the development budget approved by Tenant's construction lender prior to or in connection with closing the Construction Loan and ITHPC.

Recommendation # 10: Execute a written supplement to the Lease setting forth the ITHPC as required by Section 6.09 of the Lease.

EDC's Response: EDC will follow-up and execute a written supplement setting forth $113,330,262 as the ITHPC.

Recommendation # 11: Ensure that Sunstone properly calculates the Formula Percentage Rent in accordance with the Lease.

EDC's Response: Sunstone has been calculating Percentage Rent based on the Example of Percentage Rent Calculation in Exhibit A of the Lease. This is the same way it has been calculated since 1998 and accepted by 42DP, however, it is different from how it is written in the body of the Lease which is the basis of the Comptroller's finding.

EDC has reviewed the methodology presented in the Comptroller's Audit Report and agrees with the interpretation. We also agree that that this will not result in additional rent for the audit period. Due to the discrepancy however, EDC believes that a clarification of the Lease is necessary and will engage Sunstone in this regard. EDC will also ensure that Sunstone calculates the Percentage Rent accordingly.

Recommendation # 12: Routinely demand and review the monthly and annual reports submitted by Sunstone to ensure the accuracy of the calculation of the Formula Percentage Rent.

EDC's Response: EDC reviews the Quarterly and Annual Verified Statement of Percentage Rent and Adjusted Gross Revenues reports submitted by Sunstone. Nevertheless, EDC agrees with this recommendation and going forward plans to routinely demand and review the required monthly and annual reports to ensure the accuracy of the Percentage Rent calculation in accordance with the clarification discussed above.

Recommendation # 13: Ensure that Sunstone replenishes $4,424,615 to the FF&E reserve account.

EDC's Response: EDC agrees that maintaining a FF&E account is appropriate and intends to ensure that the proper amount is funded and maintained in the future.

Recommendation # 14: Ensure that Sunstone submits to EDC, in the manner and time frames specified by the Lease, required financial and operating reports including but not limited to: annual audited property-level financial statements; monthly STR reports comparing Hilton's performance to that of the Competitive Set regarding occupancy, average room rate, and other data; property inspection reports; and certified FF&E reserve account depository statements, and budgeted and actual utilization reports with explanations of variances.

EDC's Response: EDC agrees that receipt of these reports is important and will monitor and enforce the Lease as it relates to these requirements.. Sunstone has indicated that prospectively they will provide annual audited property-level financial statements as well as the other required reports and work with EDC to assure they are in acceptable form.

Thank you for the opportunity to respond to the recommendations in the audit report. Should you have any questions or concerns regarding EDC's responses, please feel free to contact Darryl Connelly at 212-618-5715 or via e-mail at dconnelly@nycedc.com.

Sincerely,

John Ciderello
Executive Vice President

cc: Kyle Kimball
Kim Vaccari
Zachary Smith
Spencer Hobson
Bulent Celik
Darryl Connelly
John McGlynn
Steve Lazarus

Exhibit A

Letter from Forest City (7/25/14)

FOREST CITY RATNER COMPANIES
1 Metro Tech Center, 23rd Floor
Brooklyn, NY 11201

July 25, 2014

VIA U.S. Mail and Email

New York City Economic Development Corporation
110 William Street, Third Floor
New York, New York 10038
Attention: Mr. Leonard Wasserman
Email: Lwasserman@nycedc.com

Re: Agreement of Lease by and between 42nd St. Development Project, Inc., as Landlord ("Landlord") and FC 42 Hotel LLC, as Tenant ("Former Tenant"), dated November 5, 1998 (the "Lease")

Ladies and Gentlemen:

Reference is made to (i) the Lease and (ii) that certain Building Loan Agreement, dated as of November 13, 1998, among Tenant, as Borrower, Credit Lyonnais New York Branch, as administrative agent (in such capacity, "**Administrative Agent**") and the Lenders named therein and from time to time party thereto, a copy of which is attached to this letter as **Exhibit A** (the "**Loan Agreement**"). Capitalized terms used in this letter but not defined herein shall have the meanings set forth in the Lease.

On behalf of Former Tenant, we have been advised that Landlord is in the process of undergoing an internal audit of its investments in the 42nd Street Project (the "**Internal Audit**"), which Internal Audit includes an analysis of Percentage Rent paid under the Lease from time to time during the period Former Tenant was the "Tenant" under the Lease. To calculate the amount of Percentage Rent due and owning under the Lease from time to time, one must establish the Initial Total Hotel Project Cost. Under the Lease, the Initial Total Hotel Project Cost is the estimated cost of completing the Construction Work and preparing the Hotel Project for opening, as set forth in the development budget last approved by Administrative Agent in connection with the Construction Loan made, in part, pursuant to the Loan Agreement (the "**Approved Construction Budget**"). A form of the development budget is attached to the Lease as Schedule P (the "**Schedule P Budget**").

Capitalized terms used in this paragraph and not defined in this letter shall have the meanings assigned thereto in the Loan Agreement. Section 2.2(a) of the Loan Agreement provides that Disbursements of the Building Loan are made in accordance with Requests for

Disbursements submitted by Former Tenant and approved by Administrative Agent and on the basis of, among other things, Line Items specified in the Budget. Under the Loan Agreement, the Budget means the budget for construction of the Required Improvements (i.e., the Hotel Project) prepared by Former Tenant and *approved by the Administrative Agent.* In addition, Section 7.3 of the Loan Agreement provides that Former Tenant shall, concurrently with each Request for Disbursement, furnish to Administrative Agent a copy of the Budget, marked to indicate any changes made through that date.

To establish the Approved Construction Budget, and, thus, the Initial Total Hotel Project Cost, attached please find (i) Requisition #1, which was submitted to Administrative Agent together with the first Request for Disbursement under the Loan Agreement in 1998 (the "**1st Requisition**") and (ii) Requisition #17, which was submitted to Administrative Agent together with the seventeenth Request for Disbursement dated April 25, 2000 (the "**17th Requisition**", and together with the 1st Requisition, the "**Requisitions**"). In accordance with the terms of the Loan Agreement, each Requisition contains a copy of the Budget with a summary page including a column marked "Original Budget" and another column marked "Updated Budget". The final row titled "Total Project Cost" totals every line item of the Budget and, for each column in each Requisition, equals $113,330,262. The "Total Project Costs" set forth in the Schedule P Budget also equals $113,330,262. Because by definition the Budget was *approved by Administrative Agent* in accordance with the term of the Loan Agreement, the "Original Budget" column of each Requisition, which is identical to the Schedule P Budget, should constitute the Approved Construction Budget for purposes of your Internal Audit.

Pursuant to that certain Assignment and Assumption of Ground Lease (Direct Lease), dated March 17th, 2006 (the "**Transfer Date**"), made by Former Tenant to Sunstone 42nd Street, LLC, a Delaware limited liability company ("**New Tenant**") and acknowledged and agreed to by Landlord and the New York City Economic Development Corporation, as agent for the City of New York (the "**NYCEDC**") recorded with the Office of the City Register for the City of New York as CRFN No. 2006000196259, Former Tenant assigned all of its right, title and interest in and to the Lease to New Tenant and was released from all Obligations under the Lease arising after the Transfer Date. Please be advised that this letter, together with each exhibit, is being sent as an accommodation to assist Landlord and the NYCEDC in connection with the Internal Audit and not in response to, or otherwise in connection with, the exercise of Landlord's and/or the Comptroller's audit rights under Section 3.13 of the Lease. Pursuant to Section 3.13(a) of the Lease, Landlord's and/or the Comptroller's rights to audit Former Tenant's calculations of Percentage Rent or any other amounts due and owning under the Lease during the period prior to the Transfer Date have expired and this letter is not intended to, and shall not be construed to, revive in any manner or respect, Landlord's and/or Comptroller's audit rights with respect to such period.

Please contact the undersigned at (718) 923-8543 or rzuckerman@fcrc.com with any questions with respect to the contents of this letter.

Very truly yours,

Name: Russell B. Zuckerman
Title: Associate General Counsel

cc: David Berliner, Esq.
David Esterman, Esq.

Exhibit B

Project Sources of Funds

Total Equity	$24,665,262
Building Loan	$42,780,552
Project Loan	$30,884,448
Mezzanine Loan (Hilton – Promus)	$15,000,000
Total	$113,330,262

Note: Exhibit prepared by EDC from documentation provided by Forest City Ratner Companies.

Hilton

March 16, 2006

Mr. Dave Berliner
42 Hotel Member LLC
c/o FCDT Corp
One MetroTech Center North
Brooklyn, New York 11201

Re: Hilton Time Square $15,000,000.00 Mezzanine Loan

Dear Mr. Berliner:

Per your request, the total payoff amount for the above reference Mezzanine Loan between 42 Hotel Member LLC ("the Maker") and Promus Hotels, Inc., ("the Payee") is as follows:

Principal Balance	$14,864,639.21
Per Diem Interest	$3,303.25
Interest to March 16, 2006	$52,852.00
Total Payoff as of 03/16/06	**$14,917,491.21**
Interest to March 17, 2006	$56,155.25
Total Payoff as of 03/17/06	**$14,920,794.46**

The wire transfer instructions are:

Bank:	The Northern Trust Company Chicago, IL
ABA:	071000152
Beneficiary:	Hilton Notes Receivable
Account:	39179480
Reference:	Time Square loan payoff

If you have any questions, please do not hesitate to contact me at (310) 205-4485.

Sincerely,

Louise Cummings

Louise Cummings
Sr. Treasury Analyst

Hilton Hotels Corporation World Headquarters
9336 Civic Center Drive, Beverly Hills, CA 90210
Tel: +1 310 205 3303 Fax: +1 310 205 7849
Reservations: www.hilton.com or 1-800-HILTONS