

August 14, 2023

MEMORANDUM

To: Public Assets and Homelessness Committee
From: Ann Gorman, Analyst
Subject: Council Bill 120643: Commercial Lease Requirements

On August 16, the Public Assets and Homelessness Committee will discuss [Council Bill \(CB\) 120643](#), which would establish limits on certain obligations that commercial tenants may incur in committing to a space lease. Specifically, the bill would limit the aggregate maximum value of a security deposit and/or letters of credit that a commercial lessor may include in a lease, and it would also limit the maximum personal guaranty that may likewise be included.

This memorandum describes the bill and discusses potential next steps.

Background

Standard commercial lease agreements generally require at least one of the following commitments by the tenant business. These commitments may be included in the lease itself or executed as a condition of the lease.

Personal Guaranty

Of the three commitments described here, a personal guaranty is most commonly required of a commercial tenant. It is an obligation to pay, over time, certain specified costs associated with the commercial tenancy. It is a “personal” guaranty because the obligation is assumed by an individual, not a business; typically, this individual is an owner of the business, but this is not always the case. For instance, someone may be willing to take on a personal guaranty on behalf of a family member to help that family member establish a new business.

The personal guaranty persists in the event that a business ceases to operate. If a business owner has committed to a personal guaranty of five years’ duration and the business ceases to operate after three years, the guarantor must continue to make payments to the lessor related to the leased space, as contractually agreed, for an additional two years. The personal guaranty also can persist in the event that the lessor is able to lease the now-vacant commercial space to a successor tenant.

A personal guaranty has an element of duration, but it may also include discrete costs. If a lessor pays for the installation of a custom kitchen for a tenant restaurant business, the repayment of those costs is typically an element of the personal guaranty.

Security Deposit

A tenant of whom a security deposit is required must make a payment to the lessor before obtaining the right to occupy the leased space, which payment the lessor will retain to pay certain contractually agreed costs. Such costs often include repairs to the property responsive to damage caused by the tenant, and they may include additional costs as well. The required security deposit is often a multiplier of monthly rent payments, but paying a security deposit is a separate commitment from the regular payment of rent. The security deposit may be paid by an individual or by the tenant business.

Letters of Credit

The term “letters of credit” refers collectively to two scenarios, both of which involve a bank or other financial institution. In the first, the bank or financial institution guarantees assets of a certain contractually agreed amount, which will be used to pay the commercial business’s rent, or to meet other financial obligations, in the event that the business owner is unable to pay them. In the second, a bank or financial institution issues a line of credit that will be used for the same purpose. Letters of credit may be obtained by an individual or by the tenant business.

Council Bill 120643

CB 120643 would establish the following limits with respect to the commitments described above. These limits would apply for all new leases executed after the effective date of the legislation.

- The maximum personal guaranty that a commercial lessor could require would be the sum of two years of rent payments and the total cost of tenant improvements funded by the lessor and made to the leased space.
- The maximum total value of a required security deposit and/or letters of credit would be the sum of the first and the last month of rent payments as specified in the lease.

The bill would add a new Chapter 6.104 to Title 6 of the Seattle Municipal Code (SMC), which addresses business regulations. This chapter would constrain the applicability of the bill, for instance only to commercial property as defined therein and not to governmental and tribal entities that may be incidental lessors of commercial property.

CB 120643 would apply to newly executed commercial leases only. It would not apply to lease extensions.

Potential Impacts of CB 120643

Impact to Business Owners

There are significant costs associated with starting a new business, including permitting, recruitment and training of staff, marketing, and the commitment of capital to support the business's operating needs. In limiting the business owner's liability related to a security deposit and letters of credit, the legislation may create conditions in which the business owner can dedicate greater financial resources to those operational costs, pursuing activities that support business success and sustainment.

The sponsor of the legislation has indicated that when there are limits on the personal guaranty liability and the aggregate security deposit and letters-of-credit liability that a business owner may assume, this net reduction in liability will engender a financial benefit for the business owner in the form of greater access to credit and capital, which may be used to grow and sustain the business. This may be true to the extent that the personal guaranty is not made by a friend, family member or investor and that the reduction in liability creates additional capital for re-investment into the business. Central Staff were unable to find data or research to show how often a personal guaranty is made by a business owner as opposed to another party, nor whether the potential relief from personal-guaranty limits would result in benefits to business owners or other parties.

Stakeholder input indicates that business owners are burdened by the current lack of limitations that pertain to personal guaranties, security deposits, and letters of credit, but the City does not collect the data that would illustrate this burden. For this reason, measuring the impact of CB 120643 would be difficult.

Impact to Lessors

The bill's benefit to commercial businesses could be offset by a detriment to lessors. Lessors include personal guaranty, security deposit, and/or letter-of-credit requirements in commercial leases for a variety of reasons, including to protect their investments, to ensure that their operating costs are covered, and to earn a regular profit. Not all of these reasons pertain for every commercial lease, and not all commercial leases necessarily yield profits for a lessor. For instance, a lessor may choose to operate on a negligible profit margin in anticipation of selling the commercial property in the future, with net investment profit to be realized at that time. CB 120643 would decrement, to some degree, lessors' ability to protect their investments, cover operating costs, and earn a profit. It is possible that the imposition of the new limitations may cause some lessors to minimize these losses by raising the monthly rent or increasing maintenance or other charges in new leases.

CB 120643 would require that the business owner (or other guarantor) repay the cost of any lessor-funded tenant improvements (TIs) that were made prior to the business owner's occupation of the leased space, as part of the personal guaranty. These costs can be significant – for example, as for a custom kitchen installation, as referenced above – and CB 120643's approach to such TI costs would not have a new impact for lessors.

Enforcement

Unlike many of the business regulations described in SMC Title 6 – for instance, those that apply to transportation network companies and short-term rentals – the new requirements that CB 120643 would impose do not include an enforcement or ongoing outreach role for staff in the Consumer Protection Division of the Department of Finance and Administrative Services (FAS), which administers Title 6. The bill would require FAS to prepare a summary of the new chapter and to make it available to lessors and commercial tenants, and it would require lessors to make the same summary available to all tenants and prospective tenants. CB 120643 allows the FAS Director to investigate potential violations and issue civil citations including monetary penalties. It further provides for a lessor to seek either a mitigation hearing or a contested hearing with the City Hearing Examiner.

The bill would be an exercise of the City's police powers, which provide broad latitude to protect and promote public health, safety, and welfare.

Potential costs for enforcement are still under investigation by Central Staff and are noted in the Fiscal Note accompanying CB 120643. This document will be updated as more information becomes available.

Issues for Consideration

Economic Unknowns

It is also possible that the bill will have different impacts on lessors of commercial property and owner-lessors of commercial property. For instance, a lessor may be acting on behalf of a national commercial leasing corporation that is situated to maximize tax laws and operational efficiencies across the cities in which it operates, and this corporation would likely be well insulated from any negative financial impacts of this bill. An owner-lessor may own a building with a single ground-floor commercial retail space, and in such a case negative financial impacts would have a proportionally larger effect on the owner-lessor's operating margin. Owner-lessors of commercial property may themselves be small business owners.

CB 120643 would apply to newly executed commercial leases only, so businesses with leases that expire sooner after the legislation's passage would be able to negotiate new leases under its terms, which will provide them with a financial advantage over competitor businesses. This lack of a level playing field for businesses would persist until all current leases have expired. Some commercial lease terms are as long as 20 years.

The limitations in CB 120643 seek to expand and sustain small business ownership and economic mobility and growth for small business owners. However, it would apply to businesses of all sizes, and it is not clear that its primary benefit would be experienced by business that have been disadvantaged by the current lack of commercial-lease requirements. Economic theory suggests that lowering the financial barriers associated with starting a business could have the unintended consequence of increasing the ability of well-resourced businesses to price goods and services more competitively, driving smaller competitors out of

the market. However, Central Staff were unable to find research that clearly bore out this theory with respect to the specific barrier-lowering proposed in CB 120643.

When seeking to implement a new business regulation, the experience of other cities can be a useful reference point in understanding possible policy outcomes and administrative costs. Central Staff are not aware of any cities that have imposed similar commercial lease requirements to those in CB 120643.

Personal Guaranty Limit

The bill's personal-guaranty limit (i.e., the sum of two years of rent payments) emerged from engagement with stakeholders rather than from formal analysis. Because this stakeholder group necessarily represented a small subset of the commercial businesses that would be affected by the bill's passage, it is possible that a differently comprised group would have coalesced around different recommendations.

Race and Social Justice Considerations

As noted in the ordinance and accompanying fiscal note, studies have found that business owners of color experience various economic and financial disadvantages. Some of these disadvantages are beyond the remit of this legislation or the City's ability to mitigate. For instance, racist banking practices denied residents of the historically Black Central District access to capital that would have given them a fair ownership stake in their community¹, and studies have found that nationally, a racial capital-access gap persists to the present day² and that there is evidence of discrimination against entrepreneurs of color in obtaining credit.³ In its assumed provision of a financial benefit to those businesses that would benefit from increased access to capital and credit, CB 120643 would diminish known disadvantages.

CB 120643 is consistent with the goal of the City's Commercial Affordability Initiative, which is housed within the Equitable Development Initiative. The Commercial Affordability Initiative seeks to create new policies and steps to support commercial affordability to address the rising cost of commercial space for new businesses.

Next Steps

The Public Assets and Homelessness Committee plans to continue discussion of CB 120643 and vote on any amendments on September 6. If committee members vote on CB 120643 as amended at that meeting, it could be voted on by the City Council on September 12.

cc: Esther Handy, Director
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¹ Pulkkinen, Levi, "Displaced from the Central District (<https://www.seattlemet.com/news-and-city-life/2020/11/displaced-from-the-central-district-seattle>)," *Seattle Met*, Winter 2020

² Shapiro, Thomas, et al., Demos, "The Asset Value of Whiteness: Understanding the Racial Wealth Gap," <https://www.demos.org/research/asset-value-whiteness-understanding-racial-wealth-gap> (2017)

³ Austin, Algernon, Center for Global Policy Solutions, "The Color of Entrepreneurship: Why the Racial Gap among Firms Costs the U.S. Billions," <https://globalpolicysolutions.org/wp-content/uploads/2016/04/Color-of-Entrepreneurship-report-final.pdf> (2016)