CALIFORNIA BUSINESS PROPERTIES ASSOCIATION

1121 L Street, Suite 501 · Sacramento, CA 95814 · Phone (916) 443-4676 · www.cbpa.com

Protecting commercial real estate for 50 years

Founding CEO & President Emeritus
REX S. HIME (1948-2023)

President & Chief Executive Officer
MATTHEW G. HARGROVE

Manager of Operations
CRYSTAL WHITFIELD

Director of Communications & Marketing
WILL HIXSON

Sr. Director of Government Relations
SKYLER WONNACOTT

April 22, 2024 - DRAFT

The Honorable Tom Umberg
Chair, Senate Judiciary Committee
1021 O St. Room 3240
Sacramento, CA 95814

RE: SB 1103 (Menjivar) As Amended – Commercial Lease Contract Mandates – OPPOSE

Dear Senator Umberg:

California Business Properties Association (CBPA) strongly opposes Senate Bill 1103 (Menjivar), as amended, which applies residential leasing tenant protections to business agreements which does not work for either the property owner or the businesses leasing commercial space and will hurt the small businesses the bill purports to help through its many unintended consequences.

Non-residential leases are business contracts negotiated in many different ways depending on the needs of both sides of the deal. SB 1103 will actually have negative consequences for the tenants the Senator is seeking to protect as it will severely narrow the options for small and undercapitalized companies to secure commercial space.

Recent amendments compound the initial issues created by the bill and make it far worse and all but impossible to implement. The bill now has vague mandates that show no understanding for a business-to-business contract completely disregarding many issues not dealt with in a residential lease. The state should not be trying to tip the scale for one side of what is a simple business contract negotiation.

The first major flaw in this bill is that you cannot define rent for a commercial tenant the way you can for a residential tenant and a change in rent is done completely differently as well, guided by the agreed upon contract. Residential tenants pay one amount as rent. It is listed in their lease as one number and any increase comes from notices sent to the tenant, usually on an annual basis.

Commercial tenants have multi-year leases with automatic rent increases that are listed in the lease contract. This legislation seems to propose that even though the contract lists the rent increase, the property agent must send a notice anyway to tell the tenant to pay what the tenant has already agreed to, and that the property owner loses the right to collect the new rent if a notice is not sent, voiding the contract provisions. That is an extreme and unrealistic requirement and a violation of the Contracts Clause of the U.S. Constitution.

Depending on the specific lease contract, commercial tenants pay many different components that equate to the total rent including things such as the Base Rent, taxes, insurance, utilities, common area maintenance, landscaping, parking lot, special equipment, building maintenance, janitorial, compliance with new laws and regulatory mandates, etc. Property owners often do not know the actual numbers for these items in advance and estimated numbers are calculated and sent to the tenants as soon as the budget is ready but cannot know in advance whether that number falls above or below an arbitrary percentage.

Section 1050.9(a)(1), it only includes maintenance, landscaping, security, trash, disposal (which what is “disposal”), or insurance. This section does not include real property taxes or other federal/state/local mandates that increase operational costs. One very common type of lease is a “triple net lease” that typically means that a tenant is required to pay base rent as well as costs for three types of expenses (hence, triple net): maintenance, taxes and insurance. This bill pushes the cost of property taxes off to other tenants that are not eligible for its provisions or will require the property owner to increase the base rent to cover these expenses. As well this bill does not allow for cost sharing of statewide and

local regulatory mandates such as increased energy efficiency regulations, required air quality upgrades to building systems, required ADA upgrades, just to name a few.

Another issue is that there are so many more components of operating expenses than are referenced in this bill. This list is not exhaustive, but some examples of costs that can be part of a typical commercial lease include management fees, administrative fees, capital improvements, replacements, utilities, equipment that serves the property, tenant improvements, and other property-based fees such as Business Improvement District fees, etc.

SB 1103 does not consider that some leases provide for long-term reserves for major maintenance projects to defray large bills being passed through to tenants at the time of need (i.e., replacement of a boiler or an HVAC system) that tenants, small business tenants in particular, are not able to pay.

As an example, the South Coast Air Quality Management has recently passed an Indirect Source Rule which requires properties to install certain features to reduce GHG emissions. This bill would make it all but impossible for many multi-tenant industrial properties to meet the requirements of that regulation without cost sharing with existing tenants. Non-compliance will then subject the property to fines and penalties which will put the property owner in jeopardy of bankruptcy.

Or what about a situation where a small property owner is leasing to a qualified tenant and the local utility raises energy costs used by the tenant. This bill would shift the tenants operational cost increase to the small business property owner, whereas under current leases those types of unknown increases are agreed upon by both parties up front.

One of SB 1103 major flaws is that it incorrectly assumes that all commercial leases are similar to residential leases, written as if all commercial tenants are on what is called a "full service" lease, where the Base Rent includes everything. Estimates are that less than ten percent of commercial tenants utilize this type of simple lease. The other ninety percent of commercial leases contain a Base Rent plus the other items mentioned above as separate items and as those costs go up each year, the lease spells out how those costs are apportioned. This bill severely limits a very common business practice.

Another issue is that the definition of the qualified commercial tenant does not make sense. Some businesses with very few employees, like a real estate brokerage firm, can make millions each year.

In addition, many owners who have multiple locations put each location under a different limited liability company as the tenant for liability separation purposes. Each of those LLCs may have only a few employees and therefore the tenant is "qualified" under this bill, even though the total company size is actually much larger. Yet, under this bill, that tenant can "self-certify" for each of the LLCs that that company is fits the definition.

Additionally, the bill includes restaurants, which for many properties require the most up-front investment to bring the tenant in. In many cases, especially with a start up restaurant, the property owner will take many of the up-front costs to build out the space, especially on health and safety issues like fume hoods and fire suppression systems. Those costs are then amortized and paid back over the lifetime. One way the property owner can secure that initial investment is requiring a higher security deposit to assure that the investment put into the property is recovered should the lease not go to full term. This bill would not allow that common practice – an example of something in the bill touted as a "protection" which is actually something that will remove a common tool that helps small businesses.

On the other end of the scale, the number of employees for a restaurant is also so high that many very well-to-do establishments will be able to take advantage of the provisions of this bill meant not envisioned for those businesses – again, putting the property owner at a disadvantage.

The bill also applies to all to all 501(c)3 non-profits, which includes his category includes corporations, trusts, and unincorporated associations focused on charitable, religious, scientific, literary, or educational purposes. While we all support the mission of many non-profits, these tax-exempt organizations already are receiving many financial benefits from the state and local government and mandating that a non-tax-exempt organization carry more of the load is not reasonable. Additionally, according to the IRS in 2022 there were over 1.5 million tax-exempt corporations that would qualify for benefits under SB 1103.

The idea of "self-certification" in the bill is completely unworkable and will create unnecessary conflict. Self-certification was used for some benefits during COVID and with no independent verification process, such as production of payroll records, tenants inaccurate reporting was common and almost always hurts the property owner as there is no recourse for them if there is a dispute.

Lastly, the major flaw of this bill is that it assumes all property owners are large and sophisticated companies. This is simply not true. Many retail and office properties are indeed owned by individuals and/or by the very microenterprises this bill purports to protect. But there is no protection for microenterprises that are on the property ownership side of the equation. This bill will obligate retirees, small family-run businesses, and, indeed, some immigrants trying to run a business, to subsidize another business. It takes away common tools that are used to negotiate a balanced agreement that both businesses find acceptable.

In the past, the Legislature and the State as a whole has recognized that non-residential leases are a commercial enterprise – business to business agreements that is not benefited by the state putting its finger on the scale for one side of the transaction.

SB 1103 threatens the very foundation of commercial real estate operations and the economic viability of small entities. It is crucial to recognize that SB 1103, while intended to protect, could inadvertently harm the small businesses it seeks to aid. The additional burdens placed on property owners could lead to higher costs and greater complexities, potentially stifling the economic growth and vibrancy of communities striving to attract and support these businesses.

We urge a NO vote on SB 1103. The bill, with its original and amended provisions, fails to support the diverse and dynamic needs of California's commercial leasing sector.

For further details or to discuss these concerns, please contact Skyler Wonnacott at the California Business Properties Association (CBPA) at (916) 960-3951 or swonnacott@cbpa.com.

Sincerely,

Matthew G. Hargrove
President & CEO