



Legislative Department Seattle City Council Memorandum

Date: April 20, 2012

To: Councilmembers

From: Ben Noble, Central Staff

Subject: Art Museum Debt Guarantee – Proposed Modifications to Original Agreement

Summary

Staff are currently finalizing a Council Bill that would modify the existing debt guarantee agreement between the City of Seattle, Seattle's Museum Development Authority (MDA) and the Seattle Art Museum (SAM). As detailed below, the City's debt guarantee was originally secured by a lease between SAM and Washington Mutual Bank (WAMU). The seizure of WAMU by the FDIC resulted in rejection of that lease and forced the Seattle Art Museum to find a new tenant and new source of revenue to pay the debt service on the bonds guaranteed by the City.

SAM has now secured a long-term lease with Nordstrom that will ultimately provide the revenue needed to pay off the guaranteed debt. Although there was an interruption of lease revenues and Nordstrom's lease does not yet fully cover the annual debt service costs, SAM has never missed a debt payment and appears to have the resources needed to supplement lease payments until rents are sufficient to cover the debt service costs. The City has been not called upon to make any payments and will not be under the changes authorized by this legislation.

The proposed ordinance will give the Director of the Department of Finance and Administration Services (FAS) the authority to acknowledge and accept the basic financial terms of the Nordstrom lease, waive the requirement that any approved rental agreement generate revenues in excess of annual debt service, and approve a limited amount of additional borrowing by SAM. These changes will bring SAM and the MDA into technical compliance with the debt guarantee agreement. And while, for a few years, these modifications provide marginally less security to the City than had been established under the original agreement, the changes acknowledge the large financial burden that SAM has successfully absorbed and recognize the significant financial benefits that the Nordstrom lease provides to both SAM and the City.

Background

In 2005, Council approved legislation that provided a \$60.7 million debt guarantee to the MDA. The MDA is City-chartered public development authority that was created to build the original downtown art museum building. The MDA essentially serves as landlord to SAM. The debt guarantee was one element of an overall funding and financing plan that provided approximately \$140 million for the renovation and expansion of SAM's downtown facility. At the same time,

SAM was investing roughly \$65 million in the development of the Olympic Sculpture Park. The City's debt guarantee reduced the risks of the debt issued by the MDA and thus lowered the interest rate and the annual debt service costs. These savings amounted to several hundred thousand dollars per year.

The structure of the deal and the flow of payments were somewhat complex, but it basically worked as follows:

- SAM, WAMU and the MDA entered in a condominium ownership agreement for the 16-story portion of the WAMU development located on 1st Avenue;
- WAMU owned and occupied the top four floors, and signed a long-term lease for the middle eight floors owned by SAM (thus occupying the top 12 floors);
- SAM, in turn, occupied the lower four floors, which are owned by the MDA; and
- SAM used the rent proceeds from WAMU to pay the MDA the revenues needed to cover the debt service payments on the City-guaranteed bonds.

In the event that SAM and the MDA are unable to make those debt service payments, funds would be drawn from a debt service reserve established under the agreements and funded from MDA bond proceeds. If that reserve was drawn upon and neither SAM nor the MDA were able to replenish it, the City guaranteed that it would do so. Any such payments made by the City would be considered a loan that would be repaid with interest.

In assuming this obligation, the City imposed a number of conditions to protect the City's financial position. Most relevant for consideration of the current legislation were (i) limitations on the total debt maintained by SAM, and (ii) a requirement that any lease provide rents that exceeded the MDA's debt service costs.

In 2008, WAMU was seized by the FDIC which sold it and its assets to JP Morgan Chase (Chase). The FDIC seizure also permitted Chase to reject any WAMU lease it chose not to assume. It rejected the lease with SAM. Chase stopped paying rent on the SAM-owned space in March of 2009, although it also made a \$10 Million gift to SAM (payable over five years) partially to help cushion the blow from rejection of the lease. Through the remainder of 2009 and most of 2010, floors 5-12 of the SAM-owned space were vacant. During that time SAM continued to make all necessary debt service payments. SAM continued to make these payments by both applying gifts and borrowing. SAM's payments to make up for the lost rent have totaled \$12 million to date. At no point has the City been called upon to provide any financial support.

Nordstrom Lease

In 2010, SAM secured a long-term lease with Nordstrom Inc. Given the weak market for commercial office space, SAM needed to provide Nordstrom significant lease incentives, including tenant improvements, a flexible occupancy schedule, and a rent schedule that increases over time. However, the lease does extend through 2031 when the MDA bonds are retired, and Nordstrom does not have any unilateral termination rights.

The table below compares the rents to be paid under the lease and the annual debt service costs owed on the outstanding bonds. While net rent receipts do not fully cover the debt service costs

in the initial two years of the lease (2011 and 2012), SAM has already made up the shortfall experienced in 2011 and has the resources needed to cover the \$1.27 million needed in 2012.

Bond Year (ends Sept. 30)	Net Rent	Debt Service	Net Rent > Debt Service?
2011	\$176,637	\$4,423,975	No
2012	\$3,151,898	\$4,425,225	No
2013	\$4,438,856	\$4,427,475	Yes
2014	\$4,548,032	\$4,425,475	Yes
2015	\$4,707,671	\$4,424,225	Yes
2016	\$4,962,226	\$4,428,475	Yes
...			Yes
2024	6,503,544 (maximum)	\$4,426,975	Yes
...			Yes
Lease ends in 2031			

Proposed Legislation

To conform the existing debt agreement to the new Nordstrom lease, the proposed legislation would authorize the FAS Director to make modifications in the guarantee agreement that would:

1. Allow SAM to use a portion of the lease payments from Nordstrom to pay utilities and maintenance costs until the lease converts to a configuration in which such costs will be paid directly by Nordstrom. The original agreement had not anticipated that SAM would ever have to pay such costs and simply captured all rent payments for debt service.
2. Consent to adjustments in the original guarantee that will conform the agreement to the terms of the Nordstrom lease. These adjustments acknowledge that through the initial years of the lease rental payments will fall short of the original requirement that rents exceed annual debt service costs. The original agreement was predicated on a WAMU lease that paid SAM at least 109% of debt service costs in each year. Furthermore, the agreement stipulated that if the WAMU lease were ever replaced, the new lease would provide lease payments equal to at least 120% of debt service costs. These measures provided a financial “cushion” for the City. Given the current market for downtown office space, SAM cannot realistically meet these requirements. The agreement simply recognizes this and gives the FAS Director the authority to accept the new lease as being compliant. However, to protect the City with regard to any future leasing changes, total “lockbox” deposits must provide 109% of debt service costs by September of 2016, and 120% of debt service costs by September of 2018.
3. Release approximately \$580,000 now held in the “Lock box” to pay current debt service and/or to repay SAM for previous debt service payments that were made over the past few years when rents fell short of the original plan. These funds were frozen when WAMU was seized, but use of these funds to pay debt service is consistent with the intent of the original agreement.
4. Approve a ceiling of total SAM debt of \$28 million outstanding at any given time. To exceed that ceiling, SAM would need to seek approval of the Director of FAS, who may

consent to a specific issue of debt if it will not cause the total then outstanding to exceed \$40 million. Consent to any debt that would cause the total to exceed \$40 million would require additional Council action. These changes are needed because the original agreement had included specific restrictions that prevented SAM from taking on significant additional debt without the City's permission. To address the revenue shortfalls due to WAMU's failure, SAM has had to take on additional loans, both to make debt payments and to make tenant improvements for Nordstrom. The proposed changes acknowledge this situation, but also seek to protect the City by continuing to limit the total amount of additional Museum debt.

Conclusion

The proposed modifications to the debt guarantee agreement are prudent adjustments given the circumstances surrounding the failure of WAMU. SAM has stepped up to provide the financial resources needed to avoid any direct City involvement and has now secured a lease with Nordstrom that will provide the long-term revenues needed to retire the outstanding debt. The concessions needed to conform the agreement to reflect the terms of the Nordstrom lease and SAM's additional debt burden are well worth the long-term benefits of authorizing the lease and preserving the integrity of the overall debt guarantee agreement.