

## Structuring Common Area Maintenance Provisions in Commercial Leases

Exploring Alternative Methods of Managing CAM Operating Costs

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# Structuring Common Area Maintenance Provisions in Commercial Leases

March 26, 2015

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# Basic overview of lease structures

**Ensure you consider the lease "product type"**

- 1. Net Leases**
- 2. Base Year Leases**
- 3. Modified Gross Leases**
- 4. Percentage Rent and other “hybrid” leases**
- 5. Commercial Lease Structures Overview:**

**<https://www.invigorlaw.com/understanding-commercial-lease-triple-net-nnn-base-year-gross-percentage-commercial-lease-structures/>**

# A note before we dive in: “CAM” v “Operating Expenses”

- “Operating Expenses” and “CAM Expenses” are sometimes used interchangeably
  - “CAM” generally refers to **C**ommon **A**rea **M**aintenance expenses, but the term is sometimes used imprecisely to reference all expenses to operate the building
- CAM expenses are a subcategory of operating expenses
  - Operating expenses also (generally) include insurance expenses and tax expenses
    - Operating expenses may also include non-separately metered utilities, janitorial expenses, and other expenses that are not “common” and are not insurance or tax expenses
- We are going to conflate these terms a bit today: we will primarily talk about CAM expense, but we will also talk about taxes and insurance expenses

# Consider the lease "product type": **Net Leases**

- **When you pay the operating expenses as a separate cost in addition to base rent, then the base rent is “net” of expenses;**
- **A net lease means the tenant pays some operating expenses separate from base rent;**
  - **The term “net” is used interchangeably considering there are many types of net leases, but the term more often refers to “triple net” or “absolute net”**
- **In a triple net (NNN) lease, the rent is net of the three major types of operating expenses:**
  - **common area maintenance expenses (“CAM” expenses);**
  - **tax expenses; and**
  - **insurance expenses.**
- **may see “absolute net,” double net, etc.**

## Consider the lease "product type": **Base Year Leases**

- **Base year leases are really just a modified type of gross lease—a lease where the tenant pays “gross” rent or rent that is not net of the major operating expenses**
- **Instead of actual operating costs being passed through to the tenant as in a NNN lease, in a base year lease the tenant pays the base year rent—the cost of the landlord’s expenses and profit for the first year of the lease**
- **For subsequent years, the tenant generally pays the base year rent plus the percentage of increase in expenses to operate the building as compared to the base year rent**
  - **Years following the base year often called an “expense year”**
- **“Expense Stop” is a similar concept, but instead of being expressed in terms of the operating expenses for a certain time period, the idea is expressed in terms of a certain amount per foot, i.e., \$2.00 per rentable foot per month**
  - **If the actual operating expenses exceed the stated “expense stop” amount which is paid by landlord, then tenant pays the excess.**



## Consider the lease "product type": **Modified Gross Leases**

- **A modified gross lease is a type of lease that is somewhere between a gross lease and an absolute net lease—which means it means almost anything**
- **Because the term “modified gross” means many things, it means almost nothing without more. Technically speaking, NNN leases and base year leases are a type of modified gross lease**
- **The term “modified gross lease” most often references a lease that is very close to being a gross lease, but the landlord might make the tenant pay utilities or janitorial, making the lease not quite gross**

## Consider the lease "product type": **Percentage Rent and other “hybrid” leases**

- **The underlying structure of the lease is another type (generally a modified gross or NNN lease), and the Landlord also gets an amount of additional rent that is based on a percentage of the tenant’s gross sales revenue or net income**
  - **Rarely see net income**
- **The structure generally calls for a minimum rent amount that is due every month regardless of revenue**
  - **when the tenant’s revenue reaches a hurdle (called the “breakpoint”), then the tenant must pay the landlord a share of the gross sales**
- **Operating expenses (and by extension CAM expenses) come into play, and similar issues arise when negotiating revenue and profit inclusions and exclusions**

# Why do I care about the lease structure?

- **Not all leases have “pass through” provisions that include CAM expenses**
- **Your client will need to understand the price of the lease**
- **Lease structure is often dictated by the type of market, which dictates the importance of some expenses**
  - **Be cognizant of lease structure *and* real estate market type when approaching Operating and CAM expenses**

# Differences when negotiating single or multi-tenant leases

- **Single Tenant: “CAM” is a misnomer**
  - **Essence: who pays for what as between tenant and landlord?**
- **Multi-tenant:**
  - **How might the other tenants affect the landlord’s ability to bargain?**
  - **How does the landlord create an ideal tenant mix?**
  - **How does your client fit into that mix?**
  - **What type of project is it?**
  - **What is the landlord’s cost to comply?**

# Practical: What are the incentives for each party?

- **Incentives: What the landlord is looking for with CAM expenses–inclusion**
  - Attract high quality tenants
  - Protect capital from unforeseen or uncontrollable liabilities
  - Operate efficiently
- **Incentives: What the tenant is looking for with CAM expenses–exclusion**
  - Understand the actual cost of leasing the space
    - Client understanding of the timing and cost of leasing the space, particularly variable costs
    - Controlling downside risk from unforeseen liabilities
  - Attracting high quality customers

# Tension that arises from landlord and tenant incentives

- **LL is supposed to maintain building, but as expenses increase the incentive (and often ability) to maintain the building decreases**
- **Tenant's customers generally like a well-kept space, but tenant doesn't want to pay any more than they have to for that space**
- **Potential tenants like nice buildings, but not high costs**
- **Moral: tenant generally gets what they pay for, don't abuse your tenants, and be careful not to handcuff your landlord**

# Common Landlord Drafted CAM Clauses

**Simplified:** Common Area Expenses. Landlord will arrange for and, in accordance with Section [4] of this Lease Tenant will pay for, the operation, maintenance, and repair of the Building, including, without limitation, parking lot maintenance and repair (including restriping and repaving), snow removal, common utilities, insurance, common water and sewer to maintain landscaping, replanting and other maintenance required to maintain landscaping in good appearance, cleaning and sweeping, supplies, depreciation on machinery and equipment used in such operation, personnel to implement the services, property owners' association assessments, and similar maintenance and repair costs, as well as 10% of such operation, maintenance, and repair costs to cover Landlord's administrative and overhead expenses ("Common Area Expense").

# Common Landlord Drafted CAM Clauses

- **More Specific:** In addition to the Minimum Rent provided in Article [] above, Tenant will pay to Landlord Tenant's Pro Rata Share of:

**All costs and expenses incurred with respect the maintenance, repair, replacement, and operation of the Building, land, other improvements on the land, parking lot, sidewalks, roof, exterior walls, building mechanical, plumbing, electrical, utility and other utility related systems, including, but not limited to, general building maintenance and repair costs, electricity, fuel, gas, water, sewer, common phone and fire alarm monitoring charges, waste removal, and any other utility charges, security, window washing, janitorial service and supplies, trash removal, landscaping, pest control, wages and fringe benefits payable to employees of Landlord or Landlord's managing agent whose duties are connected with the operation and maintenance of the property or other improvements on the land, amounts paid to a management firm to supervise the operation of the property provided that any such management fees shall not exceed five percent (5%) of the gross revenues of the real property, amounts paid to contractors or subcontractors for work or services performed in connection with the operation of the property or other improvements on the property, and all services, supplies, repairs, replacements, or other costs and expenses for maintaining and operating the building, property and other improvements on the property.**



# Common Landlord Drafted CAM Clauses

- **Very Specific:**

See: [www.invigorlaw.com/cam-very-specific](http://www.invigorlaw.com/cam-very-specific)

# Common CAM exclusion "buckets" negotiated by tenants

- **Bucket 1: Landlord's cost of doing business**
  - Interest on and retirement of loans
  - Costs to acquire tenants
    - Advertising and promotion
    - Legal and broker fees
    - Leasing office rent
    - Tenant improvement allowances for other tenants
  - Cost to defend against other tenants
  - General overhead expenses not attributable to management of the particular project
  - Reserves for bad debts, repairs, etc.
  - Costs to sell or finance the property
  - Cost related to defects in original design or construction
  - Costs related to government action prior to the commencement date, including environmental and tax law changes

# Common CAM exclusion "buckets" negotiated by tenants

- **Bucket 2: Expenses for landlord wrongdoing**
  - Negligence or wilful misconduct of landlord
  - Costs incurred as a result of landlord breaches
  - Fines, penalties, and legal expenses
  - Increased insurance premiums caused by landlord

# Common CAM exclusion "buckets" negotiated by tenants

- **Bucket 3:** Expenses that may not benefit tenants equally or that may be caused by other tenants
  - Costs charged to specific tenants
  - Costs of any services not made available to all tenants
  - Costs incurred as a result of the wrongdoing of other tenants

# Common CAM exclusion "buckets" negotiated by tenants

- **Bucket 4: Expenses with potential for landlord abuse**
  - Capital expenses
  - Costs for sculptures/other art
  - Reimbursed expenses
  - Wages for employees who devote only some time to project
  - Certain expenses for building concessions
  - Expenses paid to landlord subsidiaries or affiliates
  - Management fees
  - Expenses (e.g. rentals) that can be used to circumvent other exclusions (e.g. capital expenses)
  - Insurance deductibles
  - Political and charitable contributions

# Gross Up Provisions

- **Variable operating expenses incurred during the base year increased to what those variable expenses would have been had the building been 100% (or 95%) occupied**
- **Benefits tenant when occupancy is low in the base year and then increases sharply in the subsequent years**
- **Without a gross up, the base year expenses may be significantly under-stated and tenant risks substantial increases in subsequent years**
- **Can benefit landlord if the building occupancy drops after the base year**
- **Without a gross up, tenant may pay too small a share because at any time that the building is not fully occupied, the tenant's share of the expenses will be less than the base year**
- **Quasi-Gross up: When a tenant procures and pay for a service that landlord normally provides and charges as operating expense.**
- **Category protection: If a new category of expenses arises after the base year, such as earthquake insurance, calculate operating expenses as though the new category of expense applied in the base year and the entire length of the base year. This provision assures tenant that it is only paying for the "increase" portion of the operating expenses.**
- **Add-Back protection: Base Year be increased to adjust for (1) temporary or artificial reduction of the base year expenses (such as expenses covered by a contractor's warranty), or (2) any elective or artificial election to start including in operating expenses (landlord elects to maintain and operate the parking garage rather than contracting to account for and operate the parking garage separately).**
- **Critical to audit the base year since the amount of base year expenses will determine how much is paid during the entire lease term.**

# Real property and other taxes

- Typically the largest single line item
- **California's Proposition 13**
  - Base year valuation
  - Increased by 2% a year
  - Reassessed upon change in ownership or new construction
  - Gross up: Calculate as if the building fully improved with tenant improvements and 100% occupied by rent paying tenants.
  - Single tenant – right to contest taxes

# Real property and other taxes (cont.)

- **Exclusions:**
  - **excess profits taxes**
  - **franchise taxes**
  - **gift taxes**
  - **capital stock taxes**
  - **inheritance and succession taxes**
  - **estate taxes**
  - **federal and state income taxes**
  - **other taxes applied or measured by Landlord's general or net income (as opposed to rents, receipts, or income attributable to operations at the Building)**
  - **Any taxes not included on the county or city tax bill**



# Real property and other taxes (cont.)

- **Protections against increases**
  - **How likely is a large increase**
    - **First determine what is the current assessed value**
    - **How long is the term of the lease**
- **Compromises**
  - **Number of sales, such as first sale**
  - **Number of years, such as first three years**
  - **Combination of number of sales and number of years**
  - **Dollar cap**
  - **Buy back right by landlord**
- **Proposition 8**
  - **Annual reductions due to reduction in value**
  - **Adjust the base year.**

# Capital Improvements

- Exclude capital improvements or capital replacements under generally accepted accounting and management practices
- No depreciation or amortization
- Limit to “actual, reasonable and substantiated” expenses
- Capital improvements intended to reduce operating expenses
- Cost of code compliance first enacted after lease commencement date
- Amortize in equal, annual instalments, over the useful life
  - Per GAAP
  - As reasonably determined by landlord
  - As customarily done by landlords of comparable buildings
  - Per tax code.
- With no interest

# Earthquake Insurance

- Very expensive
- Not carried by all landlords
- Compromise: tenant will pay if the landlord's lender requires this insurance
- The amount has to be commercially reasonable or affordable
- Deductible is high – include in operating expenses?
- Put a cap on the tenant's overall contribution
- “Most-favored nation” approach: pay no more than any other tenant in the project.

# Management fees

- Cap based on percentage of rental income
- Size of office and number of employees
- No more than charged by landlords of comparable buildings.

# Parking facilities and misc. issues

- **Since tenant pays for the parking, then costs of the ownership, operation and maintenance of the parking facilities should not be charged to tenant – “double dipping”**
  - **Rarely agreed to – not because not rational, but not market**
- **Not collect more than 100% of operating expenses or limit to actual**
- **What if landlord has savings from single sourcing services for its entire nationwide portfolio?**

# Tenant's share of operating expenses

- Very significant issue
- Will affect how much tenant pays over life of lease
- Right to measure the premises and the “project”
  - Provide for adjustment of Base Rent, TI allowance and anything else based on square footage
  - Retroactive and prospective
- Methodology of measurement
  - BOMA or some other method

# Simpler ways of negotiating

- Smaller tenant will not enforce or know if is being billed incorrectly
- Cap based on dollar amount
- Cap based on percentage increase per year
  - Cumulative
  - Compounded
- **Controllable expenses:** Controllable Operating Expenses of the Building shall not increase more than 4% per year over the previous year, non-cumulative and non-compounded, excluding: real estate taxes; increases in utilities due to unforeseeable causes beyond Landlord's reasonable control (but not due to Landlord's acts, omissions or voluntary decision); industry wide increases in commercially reasonable insurance costs (but not due to Landlord's election to obtain more coverage, new types of coverage or similar reasons); expenses affected by actions taken by unionized labor which are beyond Landlord's reasonable control and not due to Landlord's acts or omissions; expenses resulting from changes in Applicable Law first occurring from and after the commencement date of this Lease (and in case of an option, after start of such option period); expenses resulting from unforeseeable terrorist actions, natural disaster, or other force majeure events not due to Landlord's acts, omissions or voluntary decisions.

# A look at a “fully negotiated” CAM clause

- See: [www.invigorlaw.com/negotiated-cam-clause](http://www.invigorlaw.com/negotiated-cam-clause)



# Example “laundry list” of potential CAM exclusions

- See Prior Slide for Link to High Value Negotiated Clause
- Others:
  - Self-insurance payments
  - Repairs to roof, structural walls, foundations
  - Expenses and costs not normally included as operating expenses (in accordance with generally accepted building management or accounting principles) by landlords of similar first class office properties in the [insert city] metropolitan area.

# How to identify when it makes sense to negotiate exclusions and when it makes sense to move on

- Size of lease/value to tenant
- Downside risk associated with the particular potential expense
- Type of landlord
- Trends toward fixed CAM costs

# Some creative ways to "bridge the gap" when negotiating exclusions

- Required capital improvements v cost savings capital improvements v other capital improvements
  - The costs of capital improvements and structural repairs and replacements made in or to the Building (i) in order to conform to changes subsequent to completion of the original construction of the Building in any applicable Laws ("Required Capital Improvements"), (ii) that are designed primarily to reduce Operating Expenses or to reduce the rate of increase in Operating Expenses ("Cost Savings Improvements") and/or (iii) which are Conservation Costs (as defined below) and/or which are otherwise required in order for Landlord to operate the Building in a first class manner ("Additional Capital Improvements"). The expenditures for Required Capital Improvements, Cost Savings Improvements and Additional Capital Improvements shall be reimbursed to Landlord in equal installments over such period as reasonably determined by Landlord, together with interest on the balance of the unreimbursed expenditure at a rate reasonably determined by Landlord; provided, however, the amount to be reimbursed for any Cost Savings Improvements shall be limited in any year to the estimated reduction or estimated savings in Operating Expenses as a result thereof.
- Exclusions from exclusions =inclusions
- Caps: stay tuned for a discussion of caps

# Reminder to cross reference with other sections

- Maintenance
- Utilities and Services
- Insurance
- Etc.



# Alternate Common Area Cost Options

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# A. Common Area Maintenance Cost Caps

- CAM cost cap concerns arise in several different ways:
- 1. New Construction. If the subject property does not have an operating history, CAM costs are estimated. A tenant entering into a lease at such a property will want to mitigate its exposure to unforeseen costs or inaccurate estimates. Therefore, CAM may be capped at a not to exceed dollar value and CAM in future years may be capped at a certain percent escalation, e.g.:  
“Common Area Maintenance in the first Lease Year shall not exceed \$3.25 per square foot of rentable area comprising the Premises. Commencing as of the second Lease Year, CAM shall not increase over CAM payable by the subject tenant in the prior Lease Year by greater than 3% during each succeeding Lease Year throughout the remainder of the Term.”
- 2. Controllable v. Uncontrollable Common Area Costs. A typical method of capping CAM is to distinguish “controllable” costs from “uncontrollable” costs. Uncontrollable costs are a narrowly defined category, typically, insurance expense, snow removal expense, utility costs. Trash removal and security service costs may also be included within the category of “uncontrollable” costs. All other costs associated with CAM are deemed controllable.

- When using a “controllable” v. “uncontrollable” structure, controllable costs are typically subject to a percentage cap on annual escalations. For example: Tenant's Proportionate Share of "Controllable CAM Costs" (*i.e.*, all Costs and Expenses, except for the cost of insurance, security for the Project, snow and ice removal, utilities, and trash removal in the Common Areas) shall not increase by more than five percent (5%) of Tenant's Proportionate Share of Controllable CAM Costs actually incurred by Tenant during the immediately preceding Lease Year, calculated on a non-cumulative basis.”

In the event the tenant has an option to renew and costs are capped in this manner, the initial Lease Year with respect to the renewal term is typically not capped, but reflects actual controllable costs during such Lease Year; thereafter, controllable costs are typically subject to a percentage cap once again. For example:

“. . .; provided, however, that the limit on increases in Controllable CAM Costs shall not be applicable with respect to the first full calendar year of the first Renewal Period (it being understood that Tenant shall pay Tenant’s actual Proportionate Share of all Costs and Expenses, without regard to any limit on increases in Controllable CAM Costs, during the expressly specified calendar year and the base for purposes of calculating the foregoing cap on Controllable CAM Costs shall be re-set based on 100% of the actual costs incurred during such expressly specified calendar year).”

In the prior example, you’ll note a reference to “non-cumulative” imposition of the percentage escalator. When costs are capped, they can be capped on a “cumulative” or “non-cumulative” basis, *i.e.*, the 3% cap in the previous example is imposed throughout the term of lease with respect to a cumulative cap and the 3% increase is assessed annually, using the non-cumulative convention.



- Caps Upon Discrete Common Area Costs. CAM can also be discretely capped on an item by item basis. A common item that is capped within the litany of common area costs is the management fee, which is typically capped to a percentage of gross revenues for the building.
- Caps Based Upon Usage Types. In some instances, a building or development may be used by different user groups. For example, a predominant office building may have ground floor retail or a sub-surface food court. In some instances, the development may be condominiumized with office, multi-family and retail all units within the condominium regime. Similarly, as strip malls and shopping centers across the country lose market share to the on-line market place, alternative uses for these centers may include day care, community colleges, medical offices or out-patient clinics. It is possible to carve up costs in a myriad of ways. For example, a food court will require more janitorial services throughout the day and a different type of cleaning crew, therefore, janitorial services will probably be allocated more heavily to the percentage of square feet comprising the center that are dedicated to the food court use.

Similarly, an after-hours user, such as a community college with night classes or a day care center that has extended hours, may bear a greater burden relative to the electrical utility or snow removal services. In an office environment, if certain tenant's maintain SCIF space (Sensitive Compartmented Information Facility), there may be an additional burden placed upon the nightly cleaning staff (perhaps a security clearance is required) or there may be additional building security expenses associated with this type of tenant population. In an environment that includes medical uses, there may be an additional burden placed upon the lobby attendant or concierge and there may be an additional trash removal expense relative to medical hazardous waste. In all instances, the landlord is trying to place the greatest burden for these specialized costs upon the user population that requires or is most benefitted by the additional or greater level of service.

- The Base Year in Relation to Common Area Maintenance Costs. In some environments, a base year concept is used with respect to pass-through Common Area Maintenance Costs. Using this method, the current year CAM costs are construed to be reflected in the per square foot base rent charge. The base year is typically identified by the year upon which the lease is executed; for example a lease executed in calendar year 2015 will more than likely use the definition “Common Area Costs and Expenses incurred with respect to the Project in calendar year 2015.” Using this method, the tenant’s proportionate share of CAM is limited to the increase in CAM over the Base Year during the subject Lease Year; *e.g.*, if the Base Year CAM for 2015 is \$3.25 per square foot and actual CAM in the second Lease Year, is \$3.60, assuming a January 1 commencement date, the second Lease Year will be 2016, and tenant will be required to pay \$.35 per square foot for the second Lease Year and so on throughout the term of the subject lease. At the risk of stating the obvious, using the prior example, this tenant would have no CAM obligation throughout the remainder of calendar year 2015.

- A Modified Gross Lease. While technically not a true cap, some leases, frequently in an industrial setting, may provide for a gross base rent, *i.e.*, inclusive of CAM, but the tenant may be responsible for payment of the utilities, commonly the electrical utility. Using this methodology, the annual rent definition is qualified to provide, “*net of electric.*”
- A Different Take on Base Rent. In some instances, base rent is not based upon property values or rentable square feet, but consumption of the electrical utility. Look for this with server farms and other data warehousing facilities.
- The elements of Common Area Maintenance and the calculation thereof can be a highly creative aspect of a lease. This aspect of the lease is more of an art than a science and it is useful to understand the type of property and its tenant population when drafting this provision.

- Fixed CAM Costs. Many common area maintenance costs are fixed throughout a given measurement period. Employee costs are typically set or subject to predictable increase. Similarly, contracts for grounds maintenance, property management, lease administration, regularly scheduled maintenance of elevators, roofing and related building systems are based upon a contract rate. Each of these items that are not subject to variation based upon usage are typically established in the annual property budgeting process and not typically subject to deviation throughout the calendar year.
- The Gross Up. Many leases contain a provision whereby Common Area Maintenance costs may be “grossed up” to reflect full occupancy of the project or building. Because certain CAM costs are constant regardless of occupancy rates, the ability of the landlord to gross up CAM enables the landlord to recoup a greater portion of these costs, despite the fact that the building is not fully occupied.

- Tenants also benefit from this concept, particularly where the “base year” convention is used, *i.e.*, to the extent the base year is based upon a partially occupied building, the base year CAM will not accurately reflect CAM costs when the building is 100% occupied. In this example, building tenants may pay a higher share of CAM in the years subsequent to the base year merely attributable to the fact that the building is then- fully or near fully occupied.
- I hope this presentation was useful. If you have any questions, you may reach me by e-mail at [tmstockton@sherin.com](mailto:tmstockton@sherin.com). Thank you!

# Audit Rights

- No implied by law right to audit in California
- Implied covenant of good faith and fair dealing – right to review – McClain v. Octagon Plaza
- Protects tenant – don't have to sue
- Can also protect landlord
  - Limits or eliminates rights that tenant may otherwise legally have
  - Shorten statute of limitations
  - Limits damages
- Usually require national CPA
- Non-contingent fee auditor
- Not in default
- Copy books and records
- Confidentiality agreement by tenant and auditor
- Arbitration as dispute resolution method
- No more than once a year
- Sunset on right to audit
- Payment of audit costs if significant overstatement.