KEEPING ON COURSE
CAM RECONCILIATION PROBLEMS

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I. NEGOTIATING EXPENSE PASS-THROUGH PROVISIONS IN LEASES

A. Owners: know your property. Expenses that are not specified in the lease may not be able to be recouped. A thorough understanding of the operation of the project and anticipated future expenses is a must.

B. For tenants, understanding the pass-through expense items is an important aspect of *due diligence*. The true cost of leasing space must account for, and the tenant must budget payment of, the pass-through charges. Prospective tenants should demand historical operating expense information, and examine the landlord's characterization and treatment of expenses.

C. Common buzzwords are useful in negotiating the deal, but not in documenting the lease agreement.

1. Net, Net, Net (or triple net).

2. Modified Net.

3. Gross.

4. Modified Gross.

5. Escalators over a "base year".

D. Projecting expenses during the anticipated term of the lease.

1. What are the items of expense?

a. Taxes.

i. What is included within the definition of taxes? Special assessments? Personal property taxes? Certain items should be excluded, such as penalties and interest, excise taxes on landlord's income, and franchise, transfer, gift, estate, and succession taxes. Tax increases resulting from construction should be excluded, if the project does not benefit tenants generally or result in additional rentable area, thereby altering proportionate share.

ii. Tenant alert: sale or other transfer of a project can result in a substantial tax increase when the assessment is uncapped! Tenants should require that the lease provide that tax increases due to uncapping at sale cannot be passed on.

iii. What is included within the tax parcel? Are there taxes on lands or improvements that are not or should not be passed through to tenants?

iv. Does the tenant have a right to appeal, or to force the landlord to appeal tax assessments? Who pays for the costs and expenses of an appeal? Limit such expenses to reasonable and customary costs.

v. How are taxes prorated at the beginning and end of the lease term?

b. Utilities.

i. What utilities are included/excluded?

ii. Are utilities separately metered or sub-metered? If not, what is the mechanism for allocating utility charges among tenants? Is landlord permitted to add a markup? Who pays the cost of separately metering utilities?

c. Insurance.

i Types of Coverage

(a) Casualty Insurance.

(b) Rental interruption insurance. What is a reasonable level of coverage: Twelve months? Twenty Four months?

(c) Commercial general liability insurance. Large retail anchors have begun looking for duplicate or overlapping coverage to demand a rebate on a portion of this coverage.

(d) Pollution liability insurance.

(e) Workers' compensation insurance.

(f) Terrorism insurance.

(g) Automobile insurance.

(h) Other.

ii. Permissible pass-through coverage areas

(a) Common areas only?

(b) Entire project?

(c) Off premises support facilities, such as billboards; driveway easements, utility easements, retention ponds?

d. Maintenance.

i. Common area maintenance (CAM) in multi-tenant facilities. Virtually any item of repair and/or maintenance of the building can be included.

ii. Tenant alert: exclude these expenses.

(a) ADA compliance costs, especially when triggered by operation of another tenant.

(b) Landlord costs of enforcement against other tenants, and leasing commissions upon adding new tenants.

(c) Capital expense items. But see below, for discussion of landlord's desire to include an amortized portion of such expenses.

(d) All third party reimbursed costs, such as proceeds of insurance or condemnation.

(e) Cost of primary construction or to correct construction defects. This is especially a concern to tenants of new projects coming on line.

(f) Excessive management fees. Tenants should know who the management agent will be. Is it a person affiliated with the landlord, who is receiving a "sweetheart" fee?

(g) Fines, penalties and the like resulting from building non-compliance with applicable laws and codes.

iii. Landlord's should be sure and include:

(a) Amortization (including interest) of the cost of acquiring equipment used in maintenance.

(b) Equipment and facilities acquired by landlord to reduce energy consumption or otherwise reduce costs and expenses of operating and maintaining common areas.

(c) Salaries and compensation paid in connection with operation, maintenance and administration costs of landlord, including legal and accounting, and professional management fees (provided they are at arms-length rates).

(d) Redecorating or seasonal (holiday) decorating of common areas.

(e) Condominium dues and special assessments. The condominium format is becoming increasingly popular in the development of light industrial and high tech buildings; responsibility to pay these charges should not be overlooked in leases.

2. For each item of expense, is it a recurring expense? If so, how frequently? Weekly? Monthly? Semi-annually? Annually? Other?

3. Is landlord required to competitively bid out contracts?

4. Are affiliated party contracts permitted?

5. Is landlord required to offset income generated through use of common areas against common area expenses?

   a. ATMs/Photo Huts

   b. Event Parking

   c. Carnivals, auto/boat shows, etc.

6. How is "pro-rata" or "proportionate" share determined?

E. Know the market. Office may be treated differently than industrial, may be treated differently than retail. What do the owners of competing properties charge?

F. Payment terms.

1. Periodic (i.e., monthly) estimated payments in advance. How are estimates arrived at? When can the estimated amounts change?

   a. Landlord alert: coordinate any lender mandated expense escrows with the payment terms required of tenants.

2. Billings upon incurring of expenses. This can create cash flow problems for both landlord and tenant.

G. Negotiated caps and limits. Note: timing of any cap as between lease year versus calendar year affects both landlord and tenant.

II <u>CAPITAL EXPENDITURES AS A PASS-THROUGH EXPENSE ITEM</u>.

A. Defining the capital expenditure

1. According to GAAP.

2. According to IRS regulations.

3. Expenses in excess of a specified dollar amount.

4. Customized definition in lease.

B. Negotiating capital expenditures as an expense item to be passed through to tenants.

1. How is the amortization period determined?

2. Useful life. May require reference to manufacturer's specifications, industry experience standards, GAAP or IRS depreciation regulations.

III. <u>DEFENDING TENANT AUDITS</u>.

A. Landlords should prepare annual reconciliations of pass-through expenses, and distribute a reasonably detailed operating expense statement to tenants within a reasonable time after the end of the year.

1. What level of detail and/or documentation must the landlord provide?

2. Tenant alert: annual expense reconciliations should be required within a specified time frame and requests for adjustment thereafter should be barred.

3. Payment of any shortfall.

4. Reconciliations indicating tenant overpayment.

a. Credit against future CAM charges.

b. Reimbursement to tenant.

i. Immediate.

ii. End of lease term.

c. Penalties for overcharges can be set out in Lease.

i. Set penalty amount.

ii. Reimburse tenant its audit costs.

B. How frequently may tenants audit landlord's records? How long must Landlord maintain its books and records?

C. Who may conduct audits on behalf of tenant?

1. CPA at an hourly rate.

2. Tenant's in-house personnel.

3. Landlord alert: Prohibit audits by contingent fee lease auditors – "bounty hunters".

D. Confidentiality agreements pertaining to tenant audits. Landlords should prohibit tenants from communicating results of unfavorable audits to other project tenants.

E. Reopener clauses allow tenants to examine prior years expense reconciliations, where no challenge was made in that year, upon unfavorable audit information.

IV. SPECIAL CONSIDERATIONS FOR PROJECTS UNDER CONSTRUCTION

A. Impact on "pro-rata" or "proportionate" share determination. The pro- rata share as a moving target. When is new construction on line, such that its square footage should be included in the denominator for purposes of calculating tenants' proportionate share of expense contributions? When is new construction space "leaseable"?

B. Tenant alert: leased versus leaseable space.

C. Re-measurement upon completion of construction. Note: this can affect base rent, as well as CAM and expense contributions.