

Rent Escalation and Common Area Maintenance Clauses in Commercial Leases

Prepared by:

Marc E. Betesh, Esq., MCR.h.

KBA Lease Services



LORMAN[®]

Published on www.lorman.com - August 2017

Rent Escalation and Common Area Maintenance Clauses in Commercial Leases. ©2017 Lorman Education Services. All Rights Reserved.

INTRODUCING

Lorman's New Approach to Continuing Education

ALL-ACCESS PASS

The All-Access Pass grants you **UNLIMITED** access to Lorman's ever-growing library of training resources:

- ✓ Unlimited Live Webinars - 120 live webinars added every month
- ✓ Unlimited OnDemand and MP3 Downloads - Over 1,500 courses available
- ✓ Videos - More than 700 available
- ✓ Slide Decks - More than 1700 available
- ✓ White Papers
- ✓ Reports
- ✓ Articles
- ✓ ... and much more!

Join the thousands of other pass-holders that have already trusted us for their professional development by choosing the All-Access Pass.



Get Your All-Access Pass Today!

SAVE 20%

Learn more: www.lorman.com/pass/?s=special20

Use Discount Code Q7014393 and Priority Code 18536 to receive the 20% AAP discount.

*Discount cannot be combined with any other discounts.

RENT ESCALATION AND COMMON AREA MAINTENANCE CLAUSES IN COMMERCIAL LEASES

Marc E. Betesh, Esq., MCR.h

President

KBA Lease Services

1000 US Highway 9

Woodbridge, NJ 07095

732-750-4500 x400

www.kbalease.com

www.visuallease.com

RENT ESCALATION AND COMMON AREA MAINTENANCE CLAUSES IN COMMERCIAL LEASES

Marc E. Betesh, Esq., MCR.h

Operating Expense provisions are some of the most heavily negotiated sections in commercial leases. These provisions obligate the tenant to pay a defined share of certain defined costs of operating the building or center. This article will explore some of the key issues in negotiating and enforcing Operating Expense provisions in leases.

GROSS VERSUS NET RENTS

In real estate, some of the most commonly used terms are “Net Lease” and “Gross Lease.” Because of the many different variations on lease structures, it is important to understand what these terms refer to and how they should be used.

The terms “Net” and “Gross” refer to whether the base rent includes operating costs. When a lease is Net, it means that the base rent being paid does not include building taxes, insurance, utilities or other operating expenses. These must be paid for separately by the tenant. On the other hand, in a Gross lease the tenant pays a lump sum each month, and all of these additional costs are included in the rent.

The terms Net and Gross are often incorrectly used to refer to who performs building services. This is because in many Net leases, the tenant performs its own building services. For example, it is common to see space referred to as “Industrial NNN,” with the understanding that the tenant must perform its own building maintenance, do its own repairs and pay the building taxes and utilities. But it is also common to find a multi-tenant office building in which the landlord performs building services and then passes 100% of the costs onto the tenants. This is a Net lease as well.

There is a third type of lease: the Modified Gross lease. This is a lease in which the rent includes building expenses as in a Gross lease, but the landlord recaptures expense increases via a pass-through provision such as an operating expense, tax, or utility escalation. Some landlords use

substitute escalation provisions, such as Porters’ Wage escalations (NYC only) and CPI escalations. Modified Gross leases are most commonly found in multi-tenant office environments.

Hybrid leases mix the features of Gross, Modified Gross leases and Net leases. In these, some expenses are passed on 100% to the tenants while others are included in the rent on a gross or modified gross basis. For example, utilities and cleaning may be charged to the tenants on a Net basis (fully charged to the tenant), while operating expenses and taxes are handled on a Modified Gross basis (base amount included in the rent, with a pass-through of increases).

Because of the many different variations on these lease structures, it is highly recommended that practitioners refrain from using the terms “Gross” and “Net” in lease language. (For that matter, the practitioner should avoid use of the terms “Double-Net” or “Triple-Net” as well.) These terms can have different meanings to different people, and there is no accepted standard as to which “Net” refers to which expense. As a rule, it is always better to spell out the actual obligations of the parties.

OPERATING EXPENSE COMPONENTS

CAPITAL REPAIRS, REPLACEMENTS AND IMPROVEMENTS

As a general rule, capital expenditures are not included in tenant pass-throughs. However, there is often significant debate over what constitutes a capital expenditure for lease Operating Expense purposes.

According to GAAP (Generally Accepted Accounting Practices), capital expenditures are the acquisition costs for items that:

- Last beyond the current accounting period (the current year); and

- Increase the value or the life of an asset

The best way to understand capital expenditures is to think of them as “investments” in the building that are intended to yield long-term benefits.

Most leases have operating expense / CAM (common area maintenance) provisions that require the tenant to share in the “pot” of building operating expenses. Operating expenses typically include maintenance costs, operation costs and other normal costs of the building. When it comes to capital expenditures, most leases have language that specifically addresses how they are to be treated. The language may vary from lease to lease. This is partly because capital expenditures can take several forms including improvements, replacements and extraordinary repairs such as refurbishments and overhauls.

What is fair when it comes to capital expenditures? In most cases, the costs of capital expenditures should be borne entirely by the landlord. In order to understand why, one must first understand how the lease is structured financially.

Base rent is intended to compensate a landlord for the use of its building. The building consists of the entire structure, including all of its physical improvements, systems, equipment and other attributes. The owner’s investment in the building is allocated to each year through depreciation. The key economic model for owning commercial real estate assumes that the negotiated (base) rent being collected is sufficient to cover the annual “use” as reflected by the owner’s debt service and the building’s depreciation.

Capital Replacements

Over the years, the many component parts of a building will wear out. Therefore, eventually every component will need to be replaced. When a landlord spends money replacing a component of the building, it is simply replacing part of what the rent is already covering. There is no justification for including these replacement costs in the building operating expenses; to do so would be to charge the tenant

twice for the item - once in the rent and again in the operating expenses.

Many leases contain a capital expenditure exclusion, but then allow the inclusion of the costs of replacing an item where the expense of continued maintenance is greater than the cost to replace it. At some point in the lives of all assets, the wear and tear of normal use will become so great, or the passage of time will make them so obsolete, that the cost to repair and maintain them will be prohibitive as compared to their outright replacement.

However, this is exactly the reason assets are replaced. They have reached the end of their useful lives and need to be discarded and new, and perhaps more efficient, assets need to be acquired. This repair-vs.-replacement argument should not be used by a landlord to circumvent a lease’s capital expenditure exclusion. When an asset is replaced, the replacement is a capital expenditure that should not be included in operating expenses.

Extraordinary Repairs

In many cases, repairs can equate to replacements. Although small, routine repairs neither increase the value nor extend the life of the asset, if a repair is non-routine and rises to a level where the expenditure increases the value or life of the asset, then this constitutes what accountants call a “betterment” and the costs should be capitalized.

Capital Improvements

If a landlord puts in a new sidewalk, one can argue that the tenants are all benefiting from it, and that they therefore should pay for it. However, if these items can be included in operating expenses at the landlord’s discretion, then the landlord is essentially improving its building using the tenant’s money. Even though the tenant may receive a benefit from the new item, the tenant should, at a minimum, have the option of deciding whether it wants to spend its money on it. The landlord should first obtain the tenant’s written agreement that if such an improvement is made, they are willing to pay for their share of it by

allowing inclusion in the operating expenses. Without such approval, inclusion in the operating expenses is inappropriate.

Improvements Intended to Save Operating Expenses

Landlords are often faced with the prospect of buying equipment that can improve the efficiency of their buildings. For example, energy management systems can vastly reduce utility costs by managing the hours and extent of electrical equipment usage in a building.

Tenants should have no problem in including these costs in operating expenses provided the expenditure is spread out (amortized) over the improvement's useful life, and to the extent that the annual amortization charge is no greater than the money actually saved. Thus, it is acceptable for capital expenditures to be allowed for items that actually save other operating expenses to the extent of such savings.

Beware of clauses that say that capital expenditures are allowable if they are intended to save money, because almost anything can fit into that category. The expenditure must actually save money, and the landlord must be able to document such savings.

Improvements Required by New Laws

From time to time, laws are passed that require building owners to make improvements to their buildings (e.g., ADA, fire safety codes). These are unexpected expenditures on the part of the landlord, and a good argument can be made that the tenant should pay for them because they are not factored into the existing rent structure. An equally good argument can be made, however, that having to fund such improvements is one of the risks of building ownership, and that the tenant should be insulated from such risk. The tenant may enjoy use of the new improvement for a short time (during the balance of its lease term), but it is the landlord that now owns the new improvement forever.

Spreading Out the Cost over the Useful Life

In any case, any time that capital expenditures are allowed to be included in operating expenses, the cost must be spread out over the useful life of the expenditure. Remember that these expenditures are essentially investments in the building, and are expected to yield benefits for many years. Sound accounting principles require that in order to accurately measure and report the financial performance of an investment in real estate, the cost of such items must be allocated to the time periods they benefit. Doing so also avoids the inequitable result of having a tenant pay for the entire cost of such an expenditure in one year even though it may not be in occupancy to enjoy the benefits thereof in future years.

Capital expenditures can take the form of extraordinary repairs (such as refurbishments and overhauls), replacements and improvements. Except where the expenditure actually saves other operating expenses (and therefore has no net impact on the tenant), tenants should not allow the inclusion of such expenditures in operating expenses. These are investments in the building. They are already anticipated and covered by the existing rent and are yielding long-term benefits to the landlord almost exclusively. If, through negotiation, any of such expenditures are allowed, at a minimum they must be spread out over their useful lives so as to minimize the single-year impact they may impose.

GROSSING UP

Gross-ups are adjustments to a building's expenses to bring them up to what they would be were the building fully operational. Many leases require landlords to gross-up building operating expenses as part of the calculation of tenant pass-throughs. These gross-ups enable operating expense pass-throughs to conform to their underlying purpose. This occurs because:

- Building services are not individualized: Tenants are often required to reimburse the landlord for the tenant's fair share of building expenses. However,

services are not rendered to tenants individually; they are rendered to the building as a whole. Similarly, costs are not isolated for each individual tenant; they are aggregated for the building as a whole. They are then divided among the tenants according to their respective shares of the building.

- Building vacancy dilutes the expense total: Building vacancy reduces expenses that vary with occupancy (such as cleaning, utilities, maintenance, and supplies). Because tenants' costs are calculated based on their share of the entire building, tenants end up paying a share of a reduced expense level. As a result, the landlord may not receive the full expense reimbursement it is expecting.

GROSSING-UP A BASE YEAR

Vacancy in a base year causes recurring tenant overcharges. Vacancy can create an inequity against the tenant when it occurs in a base year. In many leases, the tenant is obligated to pay for increases in costs over what they were in an agreed-upon base year. If the building has vacancy in that year, building expenses will be abnormally low, resulting in overstated increases in later years.

This is a serious problem for tenants because a low base year will result in overstated increases for every subsequent year of the lease. Grossing-up base year fixes the problem; it results in the tenant paying for the expected increases in expenses.

FIXED VS. VARIABLE EXPENSES

Not all expenses vary in direct proportion to occupancy; many have a fixed component—a part that is unaffected by occupancy.

- Lobby and common areas must be cleaned regardless of occupancy levels
- Tenant areas must be minimally heated and ventilated even when they are vacant
- Each expense must be examined closely to determine the correct gross-up result.

GROSSING-UP FOR MORE THAN OCCUPANCY

Similar adjustments are necessary to achieve full operational cost levels; occupancy is not the only factor that causes expense levels to be unusually low.

- New building systems: warranty coverage temporarily reduces maintenance costs
- Free rent periods: temporarily reduce management fees (where fees are calculated as percentage of revenues)

If either of these occurs in an escalation year, the landlord will not be fully reimbursed for expenses. If either occurs in a base year, the tenant's increases will be overstated for the life of the lease.

LEASE AUDITING- HOW TO VERIFY PROPER ADJUSTMENTS

As with all operating expenses, having clear lease language is only the first step in managing costs. It is imperative that all calculations, including the treatment and adjustments related to grossing-up expenses, be verified by lease audit professionals to ensure that proper assumptions are made and that the intent of the lease is being followed.

AUDIT RIGHTS

In most leases, the tenant is obligated to pay for a share of building operating expenses, taxes, utilities and other costs. The provisions that impose these obligations are often complex, requiring a high level of diligence in both the landlord to bill correctly and the tenant to monitor the charges.

Audit Rights Specifically Granted by the Lease

Many leases grant tenants the right to review the books and records of the landlord to ensure that the charges are billed correctly. Similar rights exist in partnership agreements and many other types of financial contracts.

Audit rights can be found within the clauses outlining the tenant's obligations to pay these charges. These clauses

often state that, upon reasonable notice, the tenant has the right to visit the landlord's offices and review the applicable accounting records. These clauses sometimes also include procedures for resolving any disagreements that may result.

Audit Rights Granted by the Law

Every tenant has a general contract right to ensure that the bills it received are correct. This right comes from any contracting party's general right to enforce its agreement.

Other rights exist as well. Some courts have specifically read into the lease an implied right of the tenant to verify the numbers, and others have gone so far as to make an audit a precondition to the tenant's obligation to pay the invoice.

In addition, any party to a contract can bring an action for an accounting, which would require the other party to substantiate and verify the charges flowing through the agreement. Of course, if the tenant suspects an overbilling, it can always bring an action for breach of the agreement.

KEEPING TENANTS FROM CHECKING THEIR BILLS

During lease negotiations, landlords regularly try to convince tenants to willingly accept limitations of these rights. Two common ways are as follows:

Shortened Time Limits

Many landlords ask the tenant to provide a detailed written objection to the landlord's bills within a very short time period - in most cases 30-90 days - failing which the bill is "conclusive and binding" on the tenant, who is "deemed" to have agreed to the bill as rendered.

The landlord's most common argument for this limitation is that it needs to "close the books" for the year in question. Of course, the flaw in this argument is that the books for the year being billed have already been closed. (They were closed prior to rendering the statement.)

The problem with accepting this limitation is that it is virtually impossible for most tenants to determine whether there is anything wrong with the bill within 90 or even 180

days. Making such a determination often requires many steps: hiring a lease audit firm to review the lease and the bills; gathering needed internal information; coordinating schedules for an audit; conducting an on-site review of the building's books and records; completing the analysis; preparing a report; presenting the findings to the landlord. Rarely can such work be done within the time limit and the tenant rarely is able to meet the deadline.

It should be noted that without a time limitation in the lease, the tenant's right to audit is governed by the applicable statute of limitations. In most states, should a landlord bill a tenant incorrectly (*i.e.*, breach its lease agreement), depending on the jurisdiction the tenant would have four to ten years during which to bring an action against the landlord.

Thus, when a tenant agrees to limit the time to a number of days, it is severely reducing the rights it otherwise would have under the law.

Restrictions on Who Can Do the Audit

Another common restriction is to require the tenant to use a "Big-4" accounting firm, or a firm that is not compensated on a contingency fee basis. The landlord's argument here is that contingency firms are more "aggressive" in pursuing overcharges than non-contingency or accounting firms and will pursue items that are not legitimate. However, let's examine the facts:

- Contingency audit firms are very careful not to pursue claims that are not legitimate because they ultimately will not get paid for their time.
- Most audit firms are controlled directly by their clients, and by contract can't exceed their mandates.
- If contingency lease audit firms have a bias, it is the same as that of the tenant: to eliminate charges that are inconsistent with the lease. The compensation structure ensures that this goal is always in view.

The important point here is that a landlord has no legitimate interest in dictating to a tenant who can work on

its behalf. Contingency audit firms exist because tenants do not have the time to focus on these issues and cannot budget the expense needed to audit leases on an hourly or fixed-fee basis. Thus, the result of this restriction is that although the tenant has permission to verify the charges, in reality it most likely won't be able to do so.

He regularly conducts seminars on negotiating leases and controlling costs through effective lease management and auditing.

He is a graduate of Temple University and Georgetown University Law Center and is a member of the New York and New Jersey bars.

ABOUT KBA LEASE SERVICES

KBA Lease Services is the signature provider of commercial lease audit services throughout North America. Formed in 1985, KBA (formerly Kislak Lease Services) pioneered the lease audit industry, specializing in controlling occupancy costs through comprehensive lease audit programs. KBA eliminates landlord billing errors, recovers rent overpayments and ensures lease compliance. Since our inception we have reviewed over 50,000 commercial leases and recovered many millions of dollars in direct savings for our clients.

ABOUT VISUAL LEASE®

Visual Lease is KBA's easy-to-use web-based lease management software system. Because it was designed with the direct input of real estate professionals from over 100 companies, it is one of the best designed systems on the market. It is powerful enough to manage the most complex lease administration tasks, yet its unique Notebook interface and robust ad-hoc reporting makes it easy enough for novices to use. Visual Lease is fully user-customizable and is simple to manage.

MARC E. BETESH

Marc E. Betesh is the founder of KBA Lease Services, Inc. (formerly Kislak Lease Services), a specialized lease audit and management firm. Mr. Betesh has directed KBA's success since its inception in 1985. He is also the developer of Visual Lease, a lease administration software program.

Prior to establishing KBA, Mr. Betesh practiced law in New York City. He is a member of CoreNet Global, AECRE and the Association of the Bar of the City of New York.

The material appearing in this website is for informational purposes only and is not legal advice. Transmission of this information is not intended to create, and receipt does not constitute, an attorney-client relationship. The information provided herein is intended only as general information which may or may not reflect the most current developments. Although these materials may be prepared by professionals, they should not be used as a substitute for professional services. If legal or other professional advice is required, the services of a professional should be sought.

The opinions or viewpoints expressed herein do not necessarily reflect those of Lorman Education Services. All materials and content were prepared by persons and/or entities other than Lorman Education Services, and said other persons and/or entities are solely responsible for their content.

Any links to other websites are not intended to be referrals or endorsements of these sites. The links provided are maintained by the respective organizations, and they are solely responsible for the content of their own sites.