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MANAGING COMMON AREA MAINTENANCE

By Steve Bergsman | Sponsored by SIOR Foundation

The irony of Common Area Maintenance (CAM), a frequently contentious discussion in lease negotiations, is how often the end result is ignored. A tenant's representative will spend hours negotiating what the landlord can or cannot recover from the tenant while determining the tenant's rights to audit annual expenses. When the tenant is secure in the building, management often does not bother to revisit any of those provisions to ensure that the landlord's chargebacks are permitted under the lease.

"Tenants spend a ton of time and money to negotiate favorable provisions in a lease," observes Jacob Cowles, SIOR, and managing partner with Landmark Advisory Services Inc., Montreal, "but then no one checks what the lease says (or they aren't qualified to adequately interpret the lease) to ensure that the items in an annual operating expenditure reconciliation are actually permitted under the terms of the lease."

CAM OUTSIDE THE UNITED STATES

Generally speaking, CAM issues in the U.S. and Canada are the same, with one important difference: the letter of intent (LOI).

"What I've noticed in doing work in the U.S. is that the LOI is typically non-binding," says Cowles. "You outline an agreement in principal, but when you get to the lease stage, if an agreement cannot be made, the parties can walk away without much consequence. In Canada, it is different. An offer to lease is often going to be binding, subject to the parties satisfying certain conditions. Since it is a binding agreement, you want to address landlord and tenant financial implications up front as much as possible."

David Liebman, SIOR and managing broker with Merit Partners, LLC in Chicago, suggests the LOI should be more inclusive and detailed.

"Most people overlook the LOI," he says. "When it gets formed, CAM issues just get listed; typically, CAM expenses are just stated by the landlord, and nothing addresses how they can be controlled, modified, or imposed in the first place. You are at the mercy of landlords, so at the earliest time possible (and that's usually the LOI stage) you have to put in safeguards to make sure that you have a way of limiting CAM expenses as best you can."

In a typical net lease, the landlord will pass these expenses to the tenants under the theory the tenants are benefitting from all expenses incurred in maintaining, repairing, or replacing systems and components on the property. But that is not always true, says Liebman.

Take, for example, the repairing or replacing of a roof-top air conditioning and heating unit that fails. "The landlord installs a replacement unit that will have a useful life of, say, 15 to 20 years," Liebman says, "What if the tenant's lease is just five years? A pro-active tenant's attorney will insert a clause that says, 'We'll agree to repair and replacement costs based upon the useful life of that type of unit but only as it pertains to this tenant's pro-rata share of the leased space and/or the tenant's lease term.' In this way, the landlord will be prevented from imposing upon the tenant an unfair burden of repair or replacement costs."

As a tenant, you must work hard to ensure things like capital expenditures are limited in terms of how much the landlord can recover, Cowles reiterates. "It comes down to how it all could be managed from the tenant's perspective, covering concerns with the lease and fighting hard for limitations on what the landlord can and cannot recover and the manner in which certain costs are recovered."

Go back to the example of the HVAC unit on the roof of an industrial building that needs to be replaced. That is an expense

the landlord will charge back to the building's tenants, so here is where the tenant needs good representation when the lease was drawn. Cowles believes a good position for the tenant to take is to have the landlord undertake the replacement at its own expense upfront, amortizing that amount over the useful life of the equipment and including the annual amortization in operating expenses. This way, the landlord is not recapturing the full amount in one year.

WHY IS THIS IMPORTANT?

Cowles goes back to the HVAC example. The HVAC is being replaced in a building where a tenant is in the 10th year of a 10-year lease and will move out of the building at expiry. By amortizing the expense, the tenant only pays for the portion of equipment for which it derived a direct benefit.

Another important clause to include is the right of the tenant to get an accounting of the CAM, real estate, and other expenses associated with the property.

At the end of the year, the landlord will reconcile the CAM, building insurance, and real estate tax costs imposed on the tenants against the actual costs incurred on the property. Based on those actual costs, the landlord then establishes the estimated monthly amounts to be charged to the tenants in the next year and imposes those costs accordingly in the monthly rent statements issued to the tenants for taxes, CAM, and insurance, says Liebman. "At that point, the tenant might say, 'Those costs seem to be a lot higher than last year, so I should be able to come in with my accountant and review your books to validate and confirm the amounts you are charging me based on the real expenses incurred last year.'" Such clauses are typically provided by the tenant's attorney to the landlord during lease negotiations.

"...A GOOD LEASE PROVIDES FOR THE RIGHT TO AUDIT AND RECEIVE A DETAILED BREAKDOWN OF EXPENSES AND SUPPORTING INVOICES."

Cowles concurs: "It's critical to have language in the lease requiring landlords to provide supporting invoices and documentation to the tenant outlining actual expenses. The tenant should have the right to reasonably contest an expense. The landlord will want to put limitations on how long it takes for the tenant to contest. Nevertheless, a good lease provides for the right to audit and receive a detailed breakdown of expenses and supporting invoices."

WHO HAS TO PAY?

One of the biggest hot button issues is the real estate taxes, which usually is a pass-through expense. A savvy landlord will annually protest real estate taxes. The question is who is going to pay for the expense of having those taxes protested? On the rationale that the tenants are the ones who benefit by such protests, the landlord will try to pass these protest costs onto the tenants. The smart tenant will counter that the landlord (typically the property owner) realizes increased value and higher rents by keeping the real estate taxes low, so he or she is truly the main benefactor.

"One potential solution," says Liebman, "is a clause that says the tenant should not pay for protesting real estate taxes unless there is an assessment reduction and/or the real estate taxes stay the same."

One thing to keep in mind regarding managing CAM expenses, Cowles

shares, is that landlords generally do not engage in fraudulent activities or try to pad profitability through higher CAM charges. Errors and mistakes normally occur due to standardization of billing, especially in multi-tenant buildings. Also, leases are very complex documents and the accounting department of a landlord may not have the legal expertise to interpret the provisions of a lease that was drafted, negotiated, and revised by lawyers. Errors in billing can occur at that point. The tenant's payables person then has his or her own challenges understanding what the lease will allow and often ends up just paying the expense.

Individual tenants negotiate individual leases ending up with different provisions to reduce exposure, liability, and costs that can be recovered through CAM, Cowles explains. "But, most sophisticated landlords will have a standard lease template used to capture CAM expenses. So, when reconciling annual operating expense estimates, they are not looking at the nuances in every single lease, which is often where the erroneous billing will occur. It is not so much that landlords are trying to squeeze more profit; it is just a matter of convenience to standardize billing. Landlords send out a blanket statement and deal with a tenant's contestation if it arises." ▼



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