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Squaring the Circle of Mistrust: Negotiating Through Triple Net Issues

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SQUARING THE CIRCLE OF MISTRUST: NEGOTIATING THROUGH TRIPLE NET ISSUES

I. OVERVIEW

Retail shopping center rents are commonly offered on a “triple net” basis, meaning the lease provides for Tenant’s payment of “base rent” or “minimum rent” plus additional triple net (“NNN”) charges. NNN charges typically include Tenant’s pro rata share of: (i) the costs (“CAM Costs”) of common area maintenance (“CAM”); (ii) the shopping center’s real estate taxes (“Taxes”); and (iii) the costs (“Insurance Costs”) of Landlord’s shopping center insurance (“Insurance”).

A client’s leasing letter of intent often addresses only basic NNN terms, leaving the nature, treatment, and, occasionally, the amount of NNN charges to be determined through lease negotiations. The lawyer’s goal is to create clarity and certainty in finalizing the lease so the client can accurately predict future cash flows and avoid future disputes.

In contrast to many other lease provisions, Landlord and Tenant NNN positions are diametrically opposed: both parties seek to stabilize and optimize cash flows, making “win-win” solutions challenging. A “win” by one party often necessitates a “loss” for the other.

Landlords desire a predictable return on investment over time (unaffected by NNN variability) and may even structure NNN charges as a profit center (for example, by implementing a combination of NNN escalations and cost efficiencies or by charging tenants overlapping charges). Tenants similarly desire predictable costs over time (unaffected by NNN variability) but can also be wary of Landlord’s possible NNN profit center motives, lack of cost accountability, and incentives to either over-maintain or under-maintain the shopping center.

In this paper, we outline and discuss commonly contested NNN pass-through provisions, present counsel’s strategic options when negotiating NNN charges in shopping center leases and examine terms that best accommodate various types of projects and deals. The tools presented should allow participants to forge their own approach to building stronger relationships with opposing counsel and negotiating NNN provisions that reinforce Landlord-Tenant trust throughout the lease term.

II. DEFINING THE “SHOPPING CENTER” AND “COMMON AREA”

“Shopping Center” and “Common Area” definitions limit the scope of NNN charges. Generally, Landlord charges Tenant only for CAM Costs attributable to the “Common Area” and only for Taxes and Insurance Costs attributable to the “Shopping Center” (subject to exceptions related to tax parcel groupings and boundaries).

Accordingly, Landlords favor broad definitions that maximize NNN costs billable to Tenant (which thereby minimize Landlord’s unrecouped expenses). For example, depending on the type of project, Landlords may seek to define “Common Area” broadly to include (*in many cases, without limitation*) all mechanical, electrical and plumbing (“MEP”) and utility improvements and installations (not solely serving tenant premises), comfort and first aid stations, customer loading zones, delivery areas, drives, enclosed mall areas, entrances, exits, exterior ramps, exterior surfaces of Shopping Center buildings, fire corridors, landscaped and planted areas, loading docks, meeting areas, open and enclosed courts and malls (including, without limitation, for pedestrian or service use), parcel pick-up areas, parking areas, parking lot lighting, pedestrian sidewalks, public restrooms, pylon signage, ramps, roadways, roof, service facilities and equipment, sidewalks, signs, stairs, streets, truck and delivery passages, truck loading areas, washrooms, and all other improvements and equipment in the Shopping Center other than tenant premises. In addition, Landlords often reserve the right to enlarge or reduce the size or change the configuration of the Common Area.

Similarly, Landlords commonly define “Shopping Center” in a manner that gives them flexibility to enlarge, reduce, or change the area covered in the definition; “Shopping Center” may include the land and improvements presently constituting the shopping center development, may include or exclude outparcels, and may also encompass land or improvements later acquired by Landlord adjacent to the shopping center.

Tenants, on the other hand, favor narrow definitions that limit NNN charges to only those areas, improvements, and amenities directly available for use by Tenant and Tenant’s customers.

Generally, NNN charges attributable to areas or improvements benefitting a specific tenant or occupant should be fully allocated to the benefited party (e.g., exclusive parking areas, fenced outdoor display areas, exclusive loading areas, exclusive utility facilities, exclusive trash facilities, etc.). Similarly, expenses attributable to areas or improvements that are shared by two or more tenants or occupants should be allocated proportionately among the benefited parties. In some cases, equitable allocations can be established by carefully tailoring the definition of “Shopping Center” and “Common Area” (e.g., excluding the NNN costs attributable to parcels that are not made available for Tenant’s use or benefit).

A Landlord may desire to develop one or more pads out of a large parking field, which may not be specifically designated as outparcels when the lease is signed. If the lease does not deny Landlord the right to do so, then the concept of “Shopping Center” and “Common Area” will need to address whether or not and when the pad area is included or excluded. In some instances, a Landlord may wish to keep and include the pad as part of the larger development. In others, the Landlord may have a present intent to immediately sell the developed pad.

In most cases, these are among the top priorities of the negotiating attorneys which will affect the bottom line of the Landlord and Tenant over the term of the lease. These are not just contingencies that may or may not arise over the lease life—they are immediate, live lease terms with certain financial impact on clients, making the concepts and language used high priority concerns for both business and legal teams.

III. CALCULATING TENANT’S “PRO RATA” (PROPORTIONATE) SHARE

The calculation of the Tenant’s “pro rata” or “proportionate share” of NNN charges for CAM Costs, Taxes, and Insurance Costs is critical. Definitions for the numerator (typically, a measure of the square footage of the Tenant’s premises) and the denominator (typically, a measure of the leasable square footage of the shopping center) greatly impact Tenant’s billable costs and Landlord’s recovery of costs. What is claimed to be “fair” or “market” is often disputed. For example, a large or high-profile Tenant may believe it is “fair” to pay less than a strictly pro rata share because it attracts business that benefits other tenants and, hence, increases the value of Landlord’s shopping center; whereas, a Landlord might believe it is “fair” to exclude from the denominator floor area that’s not currently leased and not benefitting from or participating in the shopping center’s amenities. Specific considerations follow.

A. Measurement of Floor Area

The manner of measurement may vary from lease to lease but, within a lease, measurement of the premises and the shopping center should be consistent. Sometimes measurement clauses specifically detail measurement parameters and procedures (e.g., “. . . as determined by measuring premises from the exterior face of any exterior wall and from the center line of any demising wall, in each case excluding exterior loading docks, common corridors, and vertical penetrations”); other times, a lease will reference commonly accepted industry standards (e.g., BOMA Standard for Retail Buildings: Standard Methods of Measurement (ANSI/BOMA Z65.5-2010) or BOMA Standard for Mixed-Use Properties: Standard Methods of Measurement (ANSI/BOMA Z65.5–2012)).

Some leases will fix a Tenant’s premises square footage, or provide a maximum even if the space, after construction, measures out to be a greater size. Similarly, some Tenant’s may seek a fixed minimum number for the leasable area of the shopping center so that the Tenant’s pro rata share does not increase by way of a shrinking denominator.

In many cases, the lease will address measurement and/or re-measurement, as well as how newly discovered differences impact rent and other financial terms of the lease. After a certain time, Landlord and Tenant may agree that remeasurement of the premises becomes conclusive. In most cases, the measurement process can be handled as part of the walk-through or during the delivery/post-delivery process.

B. Numerator

The numerator includes square footage within the four walls of the premises, typically measured from the exterior face of exterior walls and centerline of any demising walls. The numerator may also include interior or exterior passageways, storage areas, service areas, exclusive loading dock areas, exterior areas for Tenant’s exclusive use (such as outdoor seating or display areas), mezzanine or basement areas, floor plan penetrations, etc. While generally special additions to floor area should be addressed in a letter of intent, they can be missed. Lawyers should carefully examine whether it is equitable to include these items in the pro rata share numerator for all NNN charges.

In many cases, the approach is determined by the type of space involved and the overall economics of the transaction. Second generation space containing 1,200 square feet will typically be handled differently than new development for a 20,000 square foot anchor.

C. Denominator.

In a pro rata share calculation, larger denominators benefit the Tenant and smaller denominators benefit the Landlord. As a starting point, the denominator in a pro rata share calculation will generally be the square footage of all leasable area of the shopping center, including the Tenant's premises. Modifications to that approach may, however, be warranted based on the nature of the shopping center and the leasing transaction. A Tenant may seek to have the denominator include all interior or exterior passageways, storage areas, service areas, exterior areas for any tenant's exclusive use (such as outdoor seating), mezzanine or basement areas, floor plan penetrations, etc. In some cases, a Tenant may be justified in a position that the denominator should include square footage for areas not located on the Landlord's property -- such as square footage on adjacent property sharing a common driveway, parking area, or other common area amenity. On the other hand, a Landlord will seek to exclude storage areas, passageways, in premises mezzanines, and other "dead space" that will never be able to be leased and bear the load of NNN expense. Both Landlord and Tenant should determine whether, how and when square footage within the shopping center reserved for specific tenants (such as anchor tenants) or separate building pads should be handled in formulating a pro rata share denominator.

D. Different Denominator for CAM Costs, Taxes, and Insurance

In some cases, a denominator might vary for different NNN costs. For example, the percentage used for determining the Tenant's pro rata share of the Taxes in a case where Landlord owns and pays taxes on the entirety of the shopping center may differ from Tenant's pro rata share percentage of the Insurance Costs where another tenant pays 100% of insurance premiums for its outparcel building and therefore is not participating in the insurance pool. However, using different denominators can become unwieldly and burdensome on lease administrators. In these cases, the parties should consider whether some of the alternate approaches discussed below make more sense.

E. "Leased Area" versus "Leasable Area"

A factor alluded to above that warrants further discussion is the difference between "leased area" and "leasable area." Landlords may try to limit the denominator to actual leased space within the shopping center, excluding from the denominator unleased space. As a result, the Tenant may be responsible for exponentially higher NNN payments. On the other hand, a Landlord would be assured of passing through 100% of NNN costs through to its tenants.

Even tenants with relatively low negotiating leverage can successfully advocate for a revision from "leased area" to "leasable area." Unfortunately, a debate over what constitutes "leasable" space often ensues. For example, as the retail landscape changes, tenants with large premises close, and Landlords work to re-tenant spaces, portions of formerly occupied premises may be "cut off" and become—incidentally or intentionally—untenantable (e.g., storage or just dead, unusable space). In such instances, the "leasable area" denominator might change.

In principle, the pro rata share calculation for any NNN charge should allocate cost responsibility equitably between the parties benefitting from the cost item. Considering all the possibilities, it is easy to see how varying the structure of the pro rata share calculation from tenant to tenant could result in a revenue-generating profit center for a Landlord or how one or more Tenant's disparate demands for limitations may place Landlord in a position of being unable to recoup all of its NNN costs.

IV. COMMON AREA MAINTENANCE (CAM) COSTS

The issue of CAM Costs is certainly the most volatile element of NNN Costs, and an important part of most modern retail leases. Traditionally, CAM Costs are a nexus where Landlord and Tenant meet every year over the term of the lease to scrutinize and evaluate their relationship and see whether the size of Landlord's circle is the same as the size of Tenant's square. This is achieved when the Landlord gets reimbursed for its NNN Costs and the Tenant's expectation on occupancy cost and the quality of Landlord's maintenance are met.

A. CAM Inclusions and Exclusions

1. General Approaches.

Generally, Landlords seek to pass through to Tenants as CAM Costs all of Landlord's costs related to shopping center maintenance, repair, and operation by way of a non-enumerated, all-encompassing definition. Tenants, on the other hand, try to limit CAM Costs to a narrow scope of enumerated CAM Cost items. In most cases, the outcome is a somewhat broad description of CAM Costs (which may contain enumerated examples), with specific negotiated exceptions. A list of possible CAM Cost exclusions has been discussed in depth by others (see, for example, *Joel R. Hall, Journey Through the Nine Circles of Hell – a Mortal's Encounter with CAM*, ***2015 ICSC Law Conference****; 63 Items to Exclude from Owner's "CAM's Costs" Definition*, ***Comm. Tenant's Lease Law Insider*** *(Feb. 2006)).*

2. Specific Concerns.

Generally, CAM exclusion lists seek to isolate and remove from the CAM Costs equation costs related to the ownership, development, and improvement of the shopping center (as opposed to pure maintenance, repair, and operation of the Common Area). Recurring flashpoints for CAM Cost exclusions are:

a. Capital Expenditures.

Tenants generally object to capital expenditures as a Landlord investment in the property, rather than a true operating cost. Moreover, capital improvements—such as new buildings, structures, complete repaving or replacement of the parking field, and other major improvements—are often expensive, substantially increasing Tenant's CAM charge. This can materially impact a Tenant's proforma operating cost projections. Tenants argue that excluding capital expenditures from CAM Costs aligns with common tax treatment (for capital expenditures). Because Landlords often depreciate capital expenditures against the property basis, a Landlord should not be able to include capital expenditures as part of the operating CAM Costs. Landlords take the position that not all capital expenditures are discretionary. Some can be triggered by unforeseeable events such as new laws, local ordinances, or insurance requirements. Moreover, significant capital improvements are just one form of capital expenditure. Many capital expenditures may not involve significant structural work and are similar to a typical repair, yet at the same time may, for tax purposes, be required to be capitalized rather than expensed and deducted.

In many cases, the parties may reach a compromise by allowing capital expenditures as a CAM pass-throughs if (1) the capital expenditure is designed and reasonably expected to reduce CAM Costs (for example, installation of energy-efficient HVAC upgrades, LED lighting, or utility upgrades), and (2) the cost of the capital expenditure is amortized over its useful life. In some cases, a Tenant may require that any amortized amount can only be included in CAM Costs to the extent actual CAM Costs savings are realized in the current year. This approach can prove challenging: the parties may disagree on the "useful life" or the cost-saving potential of the capital expenditure. As a matter of course, "straight line" type depreciation over an item's useful life is usually specified, slightly simplifying matters. Landlord and Tenant may also agree that capital expenditures may not be included as CAM Costs after a certain number of lease years have passed. They may also specify a floor on the depreciation period for some or all cost items.

The following is a simple amortization-over-useful-life example: Each year, a Landlord spends $2,500 to power wash the entire shopping center parking lot. This cost is passed through to tenants as part of CAM Costs. Then one year, Landlord purchases an automatic power washer for $20,000, with a useful life of 10 years. The resulting $2,000 pass-through is $500 less per year than Landlord's prior CAM Costs pass-through. In this example, if the Landlord uses the power washer for other properties, Tenant would be able to make a case that the amortized cost should be further reduced and allocated between the number of properties served by the equipment.

Capital replacements and capital repairs are other forms of capital expenditures. Capital replacements are new replacements of existing capital assets that have no further useful life. Capital repairs are significant repairs relating to a major component or structural portion of the property undertaken to improve or extend its normal economic life. For example, a shopping center's membrane roof may have disintegrated, resulting in ongoing leaks that cannot be abated with repair and patching. If the roof is common area under the lease (which may or not be the case), and capital replacements are included in CAM Costs, then the capital expenditure—replacing the roof—should be recoverable as a CAM Cost. In fairness to Tenant, the cost should be amortized over a long period consistent with the roof's useful life; however, even in that event, the amortized cost of a new roof is likely to be higher than periodic patching costs. In this example, the typical strategy is for the Tenant's business team to evaluate the Common Area before or during lease negotiations and obtain Landlord's commitment to upgrade elements of concern as a condition to delivery of the premises. Still, Landlords with older, second-generation space may be more reluctant to exclude capital replacements from CAM Costs than Landlords with new buildings and roof warranties. Tenants are likely to argue that the base rent paid under the lease compensates Landlord for Tenant's use of the shopping center land and improvements existing on the date of the lease, so adding capital replacements as CAM cost is tantamount to "double dipping."

Even if a Lease defaults to GAAP or IRS capital improvement standards, there is still latitude for negotiations. In some cases, a Tenant may seek to have certain expenses deemed capital expenditures and amortized under an "imputed capitalization" concept. For example, the parties could agree that any single, significant CAM Cost above a specific dollar amount (say $50,000.00) would be deemed to be a capital expenditure (even if it were not based on the definition of "capital expenditure" used in the lease) and amortized as if it were.

b. Management and Administrative Fees

Another recurring CAM Cost issue pertains to limits on management fees or administrative fees. Quite often, this issue is addressed by Landlord and Tenant as a deal point in the letter of intent preceding the preparation of the lease. If the Landlord retains a property management company (whether affiliated or not), the Landlord will seek to pass that cost through as a CAM Cost. Depending on the market, property management fees are usually in the 3% to 5% range, with that percentage being applied to all rent collected – both minimum rent and NNN charges. Because management fees are usually calculated this way, a Tenant should not only seek a maximum percentage rate (e.g., "Any property management fees in excess of 3% shall be excluded from CAM Costs"), but also define what that rate applies to (e.g., "Any property management fees in excess of 3% of base rent and tenant pass throughs shall be excluded from CAM Costs"). Since it can be argued that property management involves much more than managing the common area (fostering tenant relationships, working on lease renewals, and working on resolving tenant disputes are a few examples), a Tenant may try to have a management fee reduced to reflect an equitable allocation of the management work represented by the management fee.

An alternative to management fees is so-called "administrative fee" which is calculated by multiplying a percentage (between 5% and 15%) to all other CAM Costs. If CAM Costs include Insurance Costs and Taxes, then consideration should be given as to whether adding any administration fee cost to these items (which do not require constant attention) as well as utility costs is appropriate.

While there may be some justification for a Landlord's insistence on charging both a management fee and an administrative fee as part of CAM Costs, the reality is almost always one or the other.

c. Insurance Costs.

Although Insurance Costs (and Taxes), including both the Landlord's premium costs and reserves for any deductibles, are usually passed through separate from CAM Costs, occasionally Insurance Costs are included as part of CAM Costs. If Insurance Costs are included in CAM, a Tenant may prohibit the Landlord from having the right to calculate a portion of the administrative or management fee (however stylized in the lease) on the amount of the premiums - the resultant cost is likely way out of proportion to the actual administrative time and cost incurred by the Landlord.

B. Caps on CAM Costs

While not a panacea to mistrust, limiting the amount of CAM Cost that a Landlord may charge Tenant can add a level of long term predictability to the Landlord – Tenant relationship. A cap on CAM Costs can also relieve the parties from the need to negotiate hard on other CAM related issues such as CAM exclusions and audit rights. CAM Caps are not, however, without their critics. Depending on the circumstances of the specific property, a Landlord's argument against -- and a Tenant's concern about – a limit on CAM Cost pass through is that the Landlord will not make needed repair and maintenance to avoid exceeding the cap.

In many instances, a Tenant will seek to establish the maximum amount of CAM Costs the Landlord can charge Tenant for the first year of the lease term. Depending on the circumstances, a Landlord may only agree to an estimate of first year CAM – with actual first year CAM being free from any Cap. For example, in a newly constructed or redeveloped shopping center, the Landlord may not have enough data to allow a Landlord to commit to a first-year limitation on CAM Costs.

Caps on CAM Costs can be approached in a number of ways, and are typically described as follows (See *Betesh and Davids,* <u>*Negotiating Common Area Maintenance Costs*</u>, ***Property & Probate****, May/June 2009*):

1. Year Over Base Year

Year Over Base style limits on CAM Costs typically read as follows: "*After the first full calendar year of the Term (the "Base Year"), CAM during any calendar year of the Term shall not increase more than 5% over the Base Year on a cumulative basis.*"

A Year Over Base style cap involves a pre-agreed percentage (in this case, 5%) over the initial year of the term. Each year, the cap increases arithmetically by the same amount. Therefore, after the first year of the lease term, the cap can easily be calculated and extrapolated over the remainder of the lease term. No further calculations are needed to determine the cap.

The example used above is a non-compounded cap. The percentage used for the cap can be compounded, allowing an ever so slightly higher cap amount. This occurs because the first year cap plus the prior year's increase in the cap is being subjected to the cap percentage.

Year over Base CAM Caps are not affected by actual CAM Costs (unlike Year over Year Caps discussed below) and are generally considered to be favorable to the Landlord.

2. Year over Immediately Prior Year

More common than the Year over Base style CAM Cap is a formula that limits the amount by which CAM can increase over the immediately prior year, not a fixed base year. A common example is the following: "*After the first full calendar year of the Term, CAM during any calendar year of the Term shall not increase more than 5% of Tenant's pro rata share of CAM charged to Tenant during the previous calendar year of the Term*."

With this style of CAM cap, the cap is based on the actual amount charged to / paid by the Tenant in the prior year, not on the prior year's cap amount.

One important characteristic of this approach is that no "high watermark" is maintained, so that an abnormal year that has substantially lower CAM will lower CAM caps for future year. Consequently, this type of Cap is the most restrictive to Landlords. Although a Tenant trades off the certainty of a Year Over Base Cap, this type of Year over Year Cap may result in the Tenant's greatest savings over the term of the Lease.

The example used above is a non-compounded cap. The percentage used for the cap can be compounded, allowing an ever so slightly higher cap amount, and may allow the Landlord the opportunity to recapture slightly more CAM in years where the cap applies.

3. Year over High Watermark

A major issue of Landlords with Year over Year Caps is the resetting of the Cap when CAM Costs decline over a period of time and then rise again. If Landlord has excelled at maintaining CAM Costs, the Landlord will be penalized in future years of escalating CAM by virtue of its successful prior management. Based on this scenario, a Landlord could argue that there is no incentive to keep CAM Costs contained if it is going to lose its aggregated Cap increases. To deal with this, a Landlord will often seek a CAM cap that is based on the *highest amount of CAM for any prior year of the lease term*. Such a provision would read as follows:

> *Common Area Costs for each calendar year of the Term shall not increase more than five percent (5%) per year* ***over the greater of*** *(1) Common Area Cost charged to Tenant for the immediately prior calendar year, or (2) the highest amount of Common Area Cost charged to Tenant for any prior calendar year.*

4. Recoupment/Banking

If a Year over High Watermark type cap is not available, a recoupment or "banking" clause can be used by a Landlord to counteract the lower cap reset that can occur when declines in CAM Costs occurs when a Year over Year style cap is used. These clauses give Landlord the possibility of recouping CAM Costs not charged to a Tenant because they exceeded the applicable CAM Cap ("Unrecouped CAM").

One type of recoupment clause allows the Landlord to recapture past Unrecouped CAM amounts from Tenant in future years where actual CAM Cost is less than the CAM cap (so called "banking the overruns").

The other type of recoupment clause that allows Landlord to carry forward amounts by which actual CAM Cost is less than the CAM cap ("CAM Savings") and use those credits to charge to Tenant CAM Cost that would otherwise be Unrecouped CAM. Landlord and Tenant may have differing opinions on how long CAM Savings credits can be carried forward.

As a practical matter, administration in the form of constantly tracking recoupment amounts may prove an additional burden on the parties (especially when the Landlord may transfer ownership of the property), in which case a Cam cap that recognizes high watermarking may be considered a preferable option.

5. Typical Exclusions from Caps on CAM Costs.

CAM caps will usually certain types of expenses as "uncontrollable" as certain CAM expenses may be subject to wide swings or may be beyond the control of the Landlord. The most common CAM Cap exclusions are:

Taxes (if taxes are defined as part of CAM)
Insurance (if insurance is defined as part of CAM)
Snow and ice removal
Utility costs
Security costs
Certain governmental charges
Refuse disposal
Unforeseen expenses caused by casualty
Unforeseen expenses caused by force majeure
Expenses incurred due to change in laws, ordinances, or statutes.

V. TAXES

A. Defining Taxes.

Like CAM Costs, Landlords will generally seek to define Taxes broadly to allow it to pass through to Tenant as Taxes all taxes assessed against the shopping center. Landlord will attempt to use a non-enumerated, all-encompassing definition. For example, Landlord would seek a definition that includes all taxes, assessments, and other governmental charges, general and special, ordinary and extraordinary, direct or indirect, foreseen or unforeseen, of any kind and nature whatsoever relating to the shopping center. Landlord will also seek the right to bill Tenant for taxes and tax-like expenses that are not currently payable, but which may arise in the future. These additional taxes might arise if, for example, there is a change in the method the taxing authority calculates assessments. Other unanticipated taxes include those arising from improvements made by or for the Tenant or due to the special use of the demised premises by the Tenant.

A Tenant can try to limit Taxes to a narrow scope of enumerated items, but in most cases, the outcome will still end up being a broad description of Taxes (which may contain enumerated examples), with specific exclusions for taxes that are not directly associated with Landlord's ownership of the land and improvements constituting the shopping center. Tenant should be able to exclude interest and penalties on taxes not timely paid by the Landlord. Tenant should be able to exclude all taxes related to Landlord's income or profits generated from the operation or disposition of the shopping center (e.g., franchise, estate, inheritance, succession, transfer, income, and excess profits taxes). Note, however, that Landlord will seek to retain the right to bill Tenant for taxes based on rents or other income from the shopping center if the taxing authority implements such income or rent based tax scheme as a replacement of or supplement to the real estate taxes ordinarily imposed on the land and buildings constituting the shopping center.

B. Tax Contests

Some Tenants take a position that a Landlord generally does not have a strong incentive to contest taxes because the cost is being passed through to tenants. Most Landlords do however take a long term approach on managing their assets, which would include timely contesting Taxes. Still, a large Tenant might seek the right to contest taxes itself or the right to force Landlord to contest taxes. Only large Tenants are responsible for a large enough share of Taxes to warrant the cost of personally contesting the tax bill. Moreover, only large Tenants have the bargaining position to negotiate the right to force the Landlord to contest the tax bill. In any case, the Landlord will generally want the right to recover the cost of tax contests, whether allocated to all tenants as a component of the Taxes charge or allocated to the tenant that required Landlord to contest taxes.

VI. INSURANCE

Insurance Costs will include, at a minimum, Landlord's liability insurance (commercial general liability or CGL) and the property insurance for the shopping center improvements that are owned by Landlord. The Landlord may also seek to include premium costs for additional policies or endorsements covering risks such as flood, terrorism, or earthquake, or even D&O and other coverages. A frequent issue that arises is whether Landlord's Insurance Costs should be limited to premiums or should they include the cost of deductibles or self-insured retentions, which may include, potentially, unexpected and unmanageable large costs for one single CAM Cost year. Moreover, not all coverages or policy premiums that the Landlord seeks to pass through to the Tenant may be appropriate (e.g., D&O coverage for the Landlord's parent company, LLC, or REIT).

VII. RECONCILIATIONS, AUDITS, AND RECOUPMENT

A typical retail lease will provide a period of time within which the Landlord must deliver to the Tenant an annual reconciliation of NNN Costs following the end of the Landlord's calendar year. A Landlord's lease will typically avoid any deadline, while a Tenant's lease form will require the reconciliation be provided within a fixed period, usually within 90-150 days after the end of the calendar year. If the reconciliation is due within a certain time, consideration should be given to the ramifications of Landlord's delay. This is particularly important when the reconciliation includes an adjustment to Tenant's estimated CAM Cost for the ensuring year.

The content of this reconciliation is typically a negotiated matter in larger Tenant leases. While a Landlord's standard lease form may not require any back up at all be submitted with the reconciliation, a larger Tenant's lease may require copies of statements, invoices and other granularity. In such cases, a Landlord might balk due to the additional administrative burden of dealing with different requirements of different tenants, and the fact that larger Tenant's also successfully negotiate for separate audit rights if they contest the content of any reconciliation statement. On the other hand, providing the Tenant's required level of detail may succeed in avoiding mistrust giving rise to an audit – and all of the attending risks, costs, diversion and reallocation of personal assets that an audit involves. Usually some type of accommodation can be made that is reasonably acceptable to both parties. This can require that the Landlord provide a copy of its general ledger for the property along with a copy of the tax bill.

Many larger Tenants seek or require the right to audit the Landlord's books and records to verify that NNN Costs have been properly calculated and allocated. From the Tenant's standpoint, mere existence of the audit right can result in the Landlord maintaining a high level of respect for the lease terms relating to NNN Costs. From the Landlord's perspective, depending on its timing, the exercise of the audit right can be a major intrusion into the Landlord's business operations.

Typical issues that arise in the negotiation of an audit right are:

(a) the amount of advance notice Tenant is required to give to Landlord of the exercise of its audit right;

(b) Landlord required blackout periods for audits;

(c) where the Landlord's books and records are required to be kept (e.g., the home office or on site or near to the property, such as at a local manager's office);

(d) limitations periods;

(e) restrictions on auditors, as Landlord's generally abhor Tenants using any auditor that is compensated on a contingency fee basis and any auditor used by multiple tenants;

(f) confidentiality and non-disclosure;

(g) the timeframe for the Tenant to provide Landlord with its audit findings (e.g., within 30 - 90 days after the audit date); and

(h) the allocation and/or limitation of the Tenant (or possibly the Landlord's) audit cost depending on which party is successful, and the amount of the discrepancy revealed by the audit. Typically, a Tenant will seek to be reimbursed for audit cost if the audit reveals that Tenant has been overcharged by a stated percentage (e.g., 3 - 5% overcharge). A Landlord will, in any event, seek to cap those audit costs.

VIII. CONCLUSION

Over the term of a retail lease, NNN Costs issues are constantly operational and have recurring repercussions for the parties. In fact, many Landlords and Tenants now seek fixed CAM or gross leases to avoid the effort of having to negotiate a workable structure, not to mention the time and expense of implementing and monitoring it. But the typical shopping center lease with NNN Cost pass-throughs is still very much a central part of the industry. By recognizing the concerns of the other party to the transaction, Landlords and Tenants should be able to create legal structures which advance mutual trust and build a better working relationship.