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Workshop 24

Through the Looking Glass We Go: Everything You Wanted to Know About Triple Net Expenses in Retail Leases

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By

Michael E. Di Geronimo, Esq.
Shareholder
Miller Starr Regalia
1331 N. California Boulevard
Fifth Floor
Walnut Creek, CA 94596
michael.digeronimo@msrlegal.com
www.msrlegal.com

Karen E. Abrams, Esq.
Partner
Paris Ackerman LLP
103 Eisenhower Parkway
Roseland, New Jersey 07068
kabrams@parisackerman.com
www.parisackerman.com

I. Introductions.

A. Michael Di Geronimo
B. Karen Abrams
C. This Workshop Should be Interactive (i.e. please ask your questions or provide your comments as topics of interest are discussed)

II. Overview of Triple Net Charges in Retail Leases.

Most retail leases are structured, and can be viewed as triple net leases ("NNN"), meaning that the base rent paid to the landlord is "net" to the landlord because in addition to the base rent, the tenant also covenants to pay for its share of (1) real property taxes, (2) landlord's insurance premiums, and (3) costs incurred by the landlord to maintain and operate the center or project in which the premises is located, net of base or minimum rent. However, almost all such leases have limitations on the tenant's obligation to pay at least some of these expenses or pass-throughs. As used throughout this outline, "common area costs" refer only to those costs relating to the common area portions of the subject property and "operating expenses" refer to not only common area costs, but other costs, incurred by the landlord to own, operate, maintain, and insure other portions of the landlord's property that are not customarily treated as part of the common area, such as roofs and exterior walls. As discussed below, however, many retail leases include as part of what is defined therein as "CAM," "Common Area Costs," "Common Area Maintenance Expenses," or similar terms not only common area costs, but other types of operating expenses.

Lease provisions concerning what charges may be passed through to the tenant (particularly those dealing with common area costs and other operating expenses) are often extensively negotiated. This is not surprising since these provisions often have significant economic consequences to both parties to a lease.

Unclear and incomplete pass through provisions can, and often do, result in costly lease disputes between landlords and tenants, often characterized as one party unfairly and unexpectedly (from the alleged aggrieved party's view point) paying far too much or too little of the expenses or costs in question. However, because of the increasing complex nature of projects in which retail uses are located and the wide variety of expenses that need to be incurred to own, operate, insure, and maintain such projects, it is a difficult task to address all possible pass through expenses, limitations thereon, and exclusions therefrom in a clear and reasonably comprehensive fashion.

Perhaps in recognition of the above, leases providing for fixed common area costs and/or other operating expenses and/or placing caps on the amount of such charges appear to be becoming more prevalent.

A. Understanding the Landlord's Perspective on Triple Net Charges. The obvious motivation of almost all landlords is to operate a profitable development. Accordingly, almost all landlords share the desire to pass through to their tenants as many expenses of owning, operating, insuring and maintaining such properties as they can realistically negotiate. An idealized landlord-oriented clause in this regard may resemble something akin to the following:

> Except as otherwise expressly provided herein, it is understood and agreed that the Rent is intended and agreed to be absolutely "triple-net" to Landlord, and that Tenant shall pay and/or reimburse Landlord (within ten (10) business days after written request for same from Landlord, with reasonable supporting documentation for same) for any and all costs, expenses, and/or obligations of any kind of directly related to the operation of Tenant's business on or use of the Premises during the Term (including without limitation any amounts payable under the REA encumbering the Center or for the maintenance, repair or replacement of the Common Areas in the Center).

Market place realities, however, tend to mitigate against the ability of landlords to pass through triple net charges on an unfettered basis and/or to creatively bill for expenses over extended periods. As is the case with base rent, except in limited instances involving highly desirable locations, tenants usually opt to avoid leasing space where the additional rent payments would be significantly in excess of comparable sites.

At a minimum, a landlord needs to ensure a sufficient and reasonable level of payments from its tenants to allow the landlord to keep the common areas and other improvements maintained by the landlord in a good, attractive, and safe condition for the benefit of not only the landlord, but all project occupants and their customers, without the need to operate at a loss for any protracted period. For this reason, landlords and their representatives routinely assert with some validity that lease provisions that would deprive the landlord of the ability to have the tenant fairly share in the costs of maintaining improvements and other operating items that mutually benefit both parties, such as parking lot repairs and paving or security, are in the end counterproductive to each party's business objectives.

Most prudent or well-advised landlords will also seek to have the leases they enter into allow for a reasonable level of flexibility with respect the landlord's handling of common area costs and other operating expense. Such flexibility may extend to not only when and what costs can be passed through to the tenant, but also in terms of lease provisions granting the landlord the right to bill certain common area costs or other operating expenses to some, but not all of the tenants in a center, the right to exclude certain other tenant premises or spaces from the calculation of the tenant's share of common area costs or other operating expenses, as well the right to equitably adjust tenant's share of such costs from time to time.

B. <u>Understanding the Tenant's Perspective on Triple Net Charges</u>. While tenants want to do business in a nicely maintained center or other development, tenants are motivated to keep their rental costs as low as possible, including any amounts paid for common area costs. As a result, in dealing with common area costs and other operating expenses, tenants want to limit their allocated share of such costs as much as possible. Common methods for doing so are discussed in more detailed below, but include limiting the types of costs that can be passed onto the tenant, insisting that the tenant's share of such costs not be less than a certain specified percentage and otherwise minimizing exclusions of building areas or other tenant spaces from the calculation, and negotiating caps on such costs. It is important for a tenant to have some cost certainty for budget and other planning purposes with respect to the total amount of operating expenses being paid as additional rent under its lease. As a matter of fairness, tenants also do not want to enter into leases that allow a landlord to collect more additional rent than the landlord's actual out-of-pocket costs for operating expenses in question, and/or to allow capital improvements to be made to a center or other development paid for in whole or in part by the landlord's tenants.

III. <u>Common Area Costs and Other Operating Expenses</u>.

A. <u>Calculating the Tenant's Share.</u>

1. <u>Building to Building</u>. In most retail leases, a tenant's share of common area costs and other operating expenses are expressed on a building to building basis. In other words, a fraction, the numerator of which is the square footage of the tenant's premises and the denominator of which is the total square footage of all tenant spaces either leased or leasable ["leased" versus "leasable" also being a hotly negotiated item] in the overall center or project. By way of example, where leasable space is used in the denominator, "Tenant Share means a fraction, the numerator of which is the number of square feet of Leasable Floor Area in the Premises and the denominator of which is the number of square feet of Leasable Floor Area in the Center as of the commencement of the applicable calendar year or fiscal year (as the case may be)."

A. <u>Leased vs. Leasable</u>. Some landlord oriented leases, however, define the tenant's share as the ratio of square footage of the premises to the total square footage of tenant space that is actually leased in the center (i.e. they exclude from the denominator space that is ready to be occupied, but not actually leased and/or occupied). By way of example, "Tenant's Proportionate Share means the percentage that the Floor Area of the Premises bears to the entire leased and occupied Floor Area of the Center as reasonably determined by Landlord, except as otherwise provided herein." The obvious purpose of such a definition is to increase the tenant's share, except only in the rare instances when the center or property in question is entirely leased, so as to help ensure that the landlord's tenants are collectively paying for all of the costs in question regardless of the subject property's level of occupancy. If a tenant is unable to cause the landlord to include all leasable space (as compared to only space that is actually leased) in the calculation of tenant's share, the tenant should seek to negotiate a minimum level of deemed occupancy, e.g. "in no event shall less than 95% of the Floor Area in the Center be deemed leased and occupied for purposes of calculating Tenant's Share."

B. <u>Measuring Space: What's Included and What's Not</u>.

As a general matter, most retailers and their landlords agree that the square footage of the entirety of interior space available for the exclusive use of a tenant or tenants, as the case may be, should be used for purposes of determining a tenant's share of common area costs and other operating expenses. Such space is variously referred to with such terms as "Floor Area," "Leasable Area," or "Gross Leasable Area" or "GLA." While not universally true, the vast majority of landlords and retailers essentially agree to define such terms and measure that tenant's exclusive area in a manner similar to the following:

> As used herein, the term 'Floor Area' means all areas from time to time available, or held for the exclusive use and occupancy of occupants or future occupants of the Shopping Center (including, without limitation, mezzanines), measured from the exterior surface of exterior walls (and from extensions thereof in the case of openings) and from the center of interior demising partitions.

BOMA provides for a somewhat more complicated way of measuring retail space: GLA means "[t]he total enclosed area designated for the exclusive use of an occupant, including any basements, mezzanines, or upper floors. For each occupant, it is generally measured from the centerline of partitions that separate adjacent occupants, from the measure line on the exterior surface of exterior enclosures, from the lease line of common areas, and includes the full thickness of all other enclosing walls. No deductions is made for columns, any structural elements, or occupant voids within GLA." (Retail Buildings: Standard Methods of Measurement (ANSI/BOMA Z65.5-2010)

For purposes of calculating a tenant's share of operating expenses, the exact measuring method is usually not as important as ensuring that all applicable retail space is measured in the same manner.

Discussions do arise over whether certain types of areas should be excluded from the measurement of floor area or GLA for purposes of determining a tenant's share of common area costs and other operating expenses. Specifically, if mezzanine or upper floor of retail space is only used for storage and no office purposes, then tenants often ask, and many landlords do agree, to exclude such mezzanine space from the square footage used to calculate the tenant's share. The argument for such an exclusion is that such storage space is of limited value and usually does not require under applicable zoning codes additional parking spaces based on the square footage contained therein. If such agreement was reached, then the above referenced definition of "Floor Area" could be modified to read: "'Floor Area' means all areas from time to time available, or held for the exclusive use and occupancy of occupants or future occupants of the Shopping Center (including, without limitation, mezzanines used for the customer accessible display or sale of merchandise, provided that mezzanines used for storage or display of merchandise which is not accessible to customers and/or for general offices shall not be included in Floor Area) . . ."

Most retailers with any bargaining power decline to allow the square footage of any outdoor seating (whether exclusive to the tenant or not) to be included in the calculation of their share of operating expenses. In some cases, however, particularly where the tenant is paying base rent on such space, outdoor seating areas may be included in such calculations (e.g. “Floor Area shall mean the square footage of the Premises (and all premises in the Center, as applicable) as measured from the exterior of the outside wall to the exterior of the opposite outside wall, . . . or (ii) in the case of any outside seating area shall include the area as measured from the exterior of the outside wall to the exterior of the opposite outside wall within the outside seating area (or as measured instead from the applicable exterior Building footprint line if no such outside wall exists because the outside seating area is not bounded by four (4) full height exterior walls). . .”).

Other areas that may get excluded from square footage used to calculate the tenant’s share, or treated in a different manner, include garden centers, drive-thru lanes, exterior loading docks or areas, delivery areas, and utility rooms.

2. <u>Land to Land</u>. When a tenant is leasing not only space in a building, but also parking areas and other areas outside its building, its share of operating expenses is sometimes calculated on a land to land basis. This is particularly true in connection with ground leases. In such cases, a tenant's share could be expressed as follows: "the quotient, expressed as a percentage, when the land area of the Premises is divided by the total land area of Landlord's Parcel."

3. Maximum Share Limitations. A well represented or sophisticated tenant seeks to understand its share of operating expenses before agreeing to a deal in principle with a landlord, let alone before signing a lease. To ensure that representations about a tenant's share are accurate, besides the caps discussed below, tenants will ask to have its lease provide that (1) their share of such costs will not exceed a maximum specified percentage (e.g. "provided in no event shall Tenant's Proportionate Share exceed five percent (5%)") or (2) the gross leasable area or building area used as the denominator to calculate tenant's share on a building to building basis not to be less than a certain specified square footage (e.g. "Tenant's Proportionate Share is the ratio, stated as a percentage and applied to Common Area Expenses (including insurance costs and Real Property Taxes allocable to the Common Areas [as defined in the REA]), which is the GLA of the Building compared to the total GLA of all buildings in the Center, provided in no event shall the total GLA for the Center be deemed to be less than 125,000 square feet").

With respect to the above, it is worth noting that even pre-lease CAM estimates contained in an LOI may be actionable if they are materially inaccurate. (*See Thrifty Payless, Inc. v. The Americans at Brand, LLC* 218 Cal.App.4th 1230 (2013)).

4. Carve-Outs from the Denominator. In retail projects, it is not uncommon for outparcel tenants and certain large anchor tenants or occupants to be maintaining the common area serving their respective premises and/or to be paying common area costs or other operating expenses on a basis different than the rest of the projects' tenants. As a result, landlords want to have the ability in their leases to exclude such building space from the computation of the rest of the tenants' share of such costs. Below is an example of such a lease provision:

> "Notwithstanding anything contained in this Section of the Lease to the contrary, portions of the Project may be owned or leased from time to time by one or more persons or entities who are responsible for the maintenance, repair of and/or the payment of Taxes on all or portions of the building(s) and/or other facilities and/or Common Areas occupied or utilized by them, and the cost of such maintenance and repair would otherwise constitute Common Area Expenses ("Other Stores"). The Floor Area of such buildings in the Center shall be excluded from the denominator of the calculation of Tenant's Share of Common Area Expenses made pursuant to this Section to the extent such persons or entities are responsible for such costs (or portions thereof)."

A tenant negotiating a lease with such language included therein should seek to ascertain that such other tenants or occupants are maintaining equitable portion of the common area (i.e. the portion of the common area being maintained should be reasonably related to the use thereof by the anchor tenant or other occupant in question) and/or, if paying such costs on alternative basis, that their contributions are applied to reduce the common area costs or other operating expenses in question prior to the calculation of the negotiating tenant's share of the same.

5. Cost-Pools. Landlords also seek to have the flexibility to allocate certain common area costs to less than all tenants in project or shopping center based on a variety of factors, such as differing levels of use and, in large developments, the buildings where the subject tenants are located with lease language similar to the following: "Notwithstanding anything contained in this Lease to the contrary, at Landlord's option: Landlord shall have the right to reasonably, fairly and equitably allocate certain Common Area Expenses to less than all of the occupants in the Center, among different tenants and/or different buildings and/or different premises of the Center based upon differing levels of use, demand, risk or other distinctions among such parties, premises or buildings, in which event Tenant's Proportionate Share of such costs (the "Cost Pool") shall be as follows: (A) in the event Tenant is one of the occupants participating in such Cost Pool, its share of such Common Area Expenses shall be calculated in the manner set forth in this Lease, but the denominator used to determine such share and the total GLA of the Center shall exclude the square footage of GLA of the premises of those occupants not participating in such Cost Pool; or (B) in the event Tenant is not one of the occupants participating in such Cost Pool, then Tenant's Proportionate Share of such Common Area Expenses payable by Tenant shall be calculated in the manner set forth in this Lease, but the denominator used to determine such share and the total GLA of the Center shall exclude the square footage of GLA of the premises of those occupants participating in such Cost Pool."

At tenant faced with such clause may attempt to negotiate a right of reasonable approval of any such cost pool or, instead of giving the landlord a blanket right to include any and all common area costs therein, to limit the same to certain specified expenses (e.g. "the costs of the storm drainage facilities identified on the Site Plan").

Conversely, a tenant may wish to insist that the costs of maintaining certain portions of a center, such as food courts, which tend to have higher maintenance costs than other portions of retail project, be assigned to a cost pool that only includes the tenants located therein.

B. Common Area Costs: What's Included.

1. Strict Definition. Older retail leases tended to limit common area costs to strictly those costs incurred to maintain and repair only the common area portions of the subject center or other property, such as parking lots, sidewalks, internal drives, landscaping and mall areas available for the nonexclusive use of the property's tenants and their invitees, and no other improvements or costs. Such a definition of common area costs, which are problematic for landlords, can also still be found in tenant oriented leases. As others have noted, "the determination of whether a lease is . . . limited to common area costs or the broader operating costs is a critical issue. If the tenant successfully limits the lease to common area expenses, then the courts have repeatedly required landlords to demonstrate that any particular expense is related to the common area and not to provide more general types of services to the shopping center as a whole." (Retail Leasing: Drafting and Negotiating the Lease (CEB 2007), Section 15.3, p. 352 citing to *inter alia McDonald's Corp. v Goler* (1997) 560 N.W. 2nd 458 (holding that management expenses pertaining specifically to the common area were chargeable to the tenant, but that the portion of the management fee not related thereto could not be passed through to the tenant)).

2. Expanded to Include Other Operating Expenses. In most landlord oriented lease forms and many negotiated retail leases today, allowable common area costs are defined to include (in whole or in part) a variety of other operating expenses, such as, the costs of maintaining and repairing utility and drainage facilities serving the development as whole, fire protection lines and systems, management offices, exterior walls and surfaces, building painting and graffiti removal, community rooms, HVAC units, as well as security costs, and the wages, salaries, benefits, fees and payments to all persons engaged in the

operation, administration, and maintenance of the property. Not surprisingly, many landlord oriented forms avoid the use of the term "common area costs" or "common area expenses," and instead refer to such costs as "operating costs" or "operating expenses."

Whether roof maintenance costs are an allowable pass through to a tenant as part of common area costs is often a function of the parties' negotiation leverage, as well as in some circumstances the type of property in question. In general, landlords assert that roof (including the roof membrane) repairs and replacements are proper common area costs. Many tenant representatives disagree. Compromise positions include allowing the costs of roof maintenance, but not replacement costs, or if replacement costs are allowed, excluding any structural components of the roof therefrom, and requiring such costs to be capitalized with the tenant paying only the amortized portion thereof on a yearly basis.

Roof maintenance costs are more likely to be included in common area costs where the tenant space is part of a vertical or mixed used building. Retail tenants leasing space in such buildings may also expect that the costs of maintaining shared loading docks, rooftop equipment, and the exterior of the building will be passed through to the tenant.

The type of lease also matters in terms of what may be included in common area costs. For example, under a ground lease of an outparcel, it is highly unlike that a landlord will be able to cause any tenant with any bargaining power to pay for roof maintenance costs, or any costs related to any buildings other than the tenant's own building.

3. Management Fee and Administrative Fees. Most retail leases address in some manner a landlord's ability to include expenses for managing or administering the center or other property in question. Some leases permit the landlord to charge a "management fee," an "administration fee," or both.

While some commentators have asserted that a management fee is one paid to a third party to manage the common area or property in question and an administrative fee is one that is calculated based on a percentage of total common area costs, in practice there appears to be little difference in how the same are treated in negotiating a retail lease. Specifically, to avoid duplicative charges and prevent common area costs from becoming a profit center for the landlord, most tenants with bargaining power limit or cap all such fees on a non-duplicative basis to a range of between five percent (5%) to fifteen percent (15%) of total common area costs, with certain negotiated exclusions, such as insurance premiums, utility costs, and capital expenditures.

C. Exclusions in General. Perhaps in response to the growing list of expenses that may be passed through to a tenant under landlord oriented leases, most retail leases now contain a list of specified costs that are excluded from being passed onto the tenant as part of common area costs, which are referred to herein as "CAM exclusion(s)". Such CAM exclusions often are the most negotiated part of the lease dealing with common area costs. If drafted properly, CAM exclusions provide some certainty to the parties in terms of what expenditures may and may not be included in common area costs and, thus in theory, serve to reduce disputes over the same. Unclear or incomplete CAM exclusions, however, often have the opposite effect on the parties to the lease.

Attached to this outline are sample CAM exclusions provisions, one of which is landlord-oriented, one of which is tenant-oriented, and one of which is a negotiated CAM exclusions provision.

Below is a list of some of the more frequently negotiation CAM exclusions.

1. Capital Expenditures. From a landlord's point of view, capital expenditures are properly included in common area costs, as such are necessary to maintain a

first class center or retail project, and to continue to allow the same to be a place that customers wish to frequent. The tenant's view is that major expenditures that improve a property should be a landlord cost paid for largely out of base rent as such improvements enhance the value of the property, which the landlord, and not the tenant, owns.

Compromise positions include allowing capital expenditures to be included in common area costs, but (x) excluding capital expenditures on new construction for a specified period (usually in 5-10 year range), (y) excluding certain types of capital expenditures, such as for any structural components, or for items other than the repair or replacement of the initial Common Area improvements with substantially similar improvements (as opposed to for or relating to new construction, upgrades and/or additions to the Common Area), and (z) in all instances requiring that the costs be amortized over the useful life of the subject improvement (often with a minimum amortization period (e.g., "no less than ten (10) years"), and allowing permitting the tenant to be billed for the amortized or depreciated portion of the cost on a yearly basis.

Some tenants take the position that capital expenditures can only be included in common area costs to the extent that the same were incurred to reduce common area costs, and that the annual amortized amount of such costs to be included shall not exceed the actual annual savings in common area costs attributable to such capital expenditures.

Whether a landlord is permitted to include an interest factor as part of the amortized costs they are passing onto the tenant varies greatly from lease to lease.

What constitutes a capital expenditure for purposes of any CAM exclusion is also important to clearly specify in the lease. "Capital expenditures" are often defined by whether costs are classified as such under GAAP or IRS guidelines (e.g. " any structural repairs or any other expenditures which, in accordance with generally accepted accounting principles, are not fully chargeable to current account in the year the expenditure is incurred ('Capital Expenditures')." However, such can be problematic for a landlord in that under GAAP, and to a lesser extent under IRS guidelines any repair or improvement that has a useful life over a year can be potentially classified as a capital expenditure even if the repair or improvement in question would be viewed by most as part of routine or customary maintenance. Accordingly, to address this issue some landlords specify in their leases that certain common area costs will not be treated as capital expenditures and subject to any CAM exclusions unless they exceed a certain dollar threshold. In other words, a landlord may provide in its lease that "Common Area Costs shall specifically include capital expenditures, repairs, improvements, and replacements including, without limitation, amortization of such capital items over their useful lives (with an interest factor reasonably determined by Landlord), each of which useful life shall be reasonably determined by Landlord (provided, however, if Tenant's share of the cost of the capital expenditure would not exceed five percent (5%) of its Annual Base Rent, then Landlord shall not be obligated to amortize such capital expenditure).

On the other side of the coin, some tenants insist that any costs over a certain dollar threshold (e.g. $25,000) must be capitalized for purposes of common area costs.

2. Management and Administrative Fees. As noted above, to avoid disputes over what management and administrative fees are permitted to be included in common area costs, the lease should clearly articulate to what extent, if any, such fees may be charged to the tenant. A tenant's lawyer should include a CAM exclusion providing that except for the specified management or administrative fee expressly stated as being allowed, no other management or administrative fee of any type or nature should be permitted to be charged to tenant.

3. Hazardous Materials. Most tenants insist that common area costs will not include any costs to remediate hazardous materials or substances (excluding the costs of cleaning up routine oil spills), or the costs of any insurance to pay for the same. Some landlords nonetheless argue that such costs (if not resulting from a release caused by the landlord) should be deemed legitimate maintenance costs. On balance, it would seem appropriate for the landlord to seek to recover such costs from the responsible party (e.g. the gas station operating across the street from the center), as opposed to from its tenants.

4. Affiliated Parties. A landlord should have a right to use affiliated parties to perform common area maintenance and management services for the subject property. The tenant's legitimate concern is to make sure that such affiliated parties are not overcharging for their services. According, a CAM exclusion similar to the following should be acceptable to both parties: "amounts paid to any Affiliates of Landlord for services to the extent the same exceeds the costs of such services rendered by other first-class unaffiliated third parties on a competitive basis."

5. Insurance Deductibles. A legitimate debate exists as to whether insurance deductibles for casualty policies should be included in common area costs. A landlord will advocate that such deductibles reduce the amount of insurance premiums that the tenant has to otherwise pay for and thus, if a casualty occurs, the amount of the deductible should be fairly included in common area costs. However, since tenants do not control the amount of the deductible its landlord elects to carry (absent a rare lease provision to the contrary), a tenant can reply that it should not be penalized by its landlord's decision to carry a large deductible.

   Negotiated solutions include a CAM exclusion allowing only deductibles only if they are commercially reasonable, or, better yet from a tenant's perspective, subject to a cap thereon.

   While complicated by lease indemnity provisions, a landlord possesses the same argument outlined above for including deductibles for its commercial general liability policies insuring occurrences within the common area.

6. Management Personnel Salaries and Wages. Negotiating whether salaries and wages for landlord’s personnel or those of third parties engaged in the business of maintaining the common area or otherwise providing management and administrative services in connection with the operation of the subject property may be included in common area costs can result in both parties ending up in a quagmire. On the one hand, there is no doubt that such individuals are necessary for the maintenance and operation of the common area as well as, in most cases, other functions, the costs of which are includable in common area costs. On the other hand, it is doubtful that such individuals, particularly at the management level, spend one hundred percent of his or her time on issues concerning the common area or other matters included in common area costs, as opposed to spending some time on dealing with landlord’s other properties or with disputes, negotiations or repair items relating only to a specific tenant or tenants.

If such salaries and wages are included in common area costs, they are usually limited to those of employees or others below the level of property manager and only to the extent that the same are equitably allocated based on a fair estimate of the actual time the individuals in question spent working on common area maintenance and other reimbursable functions for the particular property in which the tenant’s premises is located.

7. Real Property Taxes and Insurance. Many retail lease forms exclude real property taxes and assessments and landlord’s insurance premiums from common area costs and make clear that such cost reimbursements are covered by other sections of the lease. However, many other retail lease forms include such insurance premiums, and to a lesser extent, at least a portion of real property taxes and assessments assessed against the landlord’s property.

If taxes and insurance are included in common area costs, the tenant may wish to specify that such will be excluded from the calculation of any management or administrative fee based on a percentage of total common area costs.

8. Mixed Used Building Exclusions. For retail tenants leasing space in a mixed used building, it is important to ensure that the lease provides that the common area costs and other operating expenses are fairly allocated among the different types of users in the building. For example, in many mixed used buildings, retail tenants have a limited use of the parking garage, as opposed to the residential tenants. Hence, it would be unreasonable in such circumstances for the retail tenants to pay more than a small percentage of the costs of maintaining the parking garage.

To this end, the various declarations, CC&Rs, and other project documents that will usually encumber a mixed used project should be scrutinized to make sure that they fairly allocate expenses among types of building uses and that the lease is consistent therewith if such is the case.

9. Compliance with Laws. A common CAM exclusion is one that precludes a landlord from recovering costs from a tenant for making improvements or repairs to the common area or other portions of its property to comply with applicable law. While a tenant may assert that any such costs constitute development costs that should be borne by the landlord, such is only really true with respect to the initial construction of the subject improvements or at least the condition of the common area improvements as of the date the tenant takes possession of its premises. Accordingly, a common negotiated compliance with laws exclusion will only apply to the extent that the common area or other applicable improvements were not in compliance with applicable laws as of the delivery date or rent commencement date under the lease.

D. Common Area Income. Tenants often assert that any income the landlord receives from allowing others to use the common area should be deducted from common area costs before a tenant’s share thereof is calculated. Examples of such revenue may include rent from food trucks, fees for advertising located in the common area, parking garage charges, and/or revenue for allowing the common area to be used for solar panels or cell towers or antennas. The tenant's rational for this assertion is that the operation and maintenance of the common area is not supposed to be a profit center, and thus common area costs should be calculated on a net basis. Landlords, however, usually feel that revenue generated from the ownership of landlord's property should not be treated differently than base or minimum rent received from its tenants. As a result, whether or what types of common area income may serve to reduce common area costs varies greatly from lease to lease.

E. <u>CAM Caps</u>.

1. <u>First-Year Caps</u>. It has become increasing common for tenants to negotiate caps on common area costs and other operating expenses for the first lease year and/or calendar year of the term. Sometimes such caps only apply to common area costs, and in other leases they are applied on a more expansive basis. Such caps are usually included at the end of the lease articles dealing with common area costs, operating expenses or additional rent, and are written in a manner similar to the following: "Notwithstanding any provision of this Lease, Tenant's Pro Rata Share of Real Property Taxes, Landlord's Insurance, and Operating Expenses from the Rent Commencement Date through the end of the first full calendar year (prorated for any partial calendar year) shall not exceed, in the aggregate, Fifteen Dollars ($15.00) per square foot of Gross Leasable Area in the Premises."

From a landlord's prospective, it is far better to only have first year caps apply to the first lease year (i.e. the 12-month period following the commencement of the term), since if it applies until the end of the first full calendar year of the term, the cap could (depending on when the term actually commences) cover a period of almost two full years.

2. <u>Cumulative and Noncumulative Ongoing CAM Caps</u>. To try to achieve some certainty with their lease costs, many regional and national tenants, as well as other retailers, seek to impose caps or limits on how much their common area costs can increase each year ("CAM Caps"). CAM Caps come in different varieties, namely those that are cumulative and/or compound in nature and those that are not.

Generally speaking, a cumulative CAM Cap is one where common area costs or other expenses subject to the same may increase by a fixed percentage each over the base year. In other words, if the base year expenses are $60,000 with a 5% cumulative cap, then the cap would be $63,000 for the first year that the cap applies and increase in the second year by 10% of the base year expenses of $60,000 or $66,000.

When some practitioners refer to a CAM Cap being cumulative, however, they mean that any prior unapplied carryovers from the cap may be applied in future years. (*See* <u>Retail Leasing</u>, <u>supra</u> at Section 15.20, p. 362.) Thus, for example, if the common area costs are subject to a 5% cap, and common area costs only go up during the first year the cap applies by 3%, then common area costs would be subject to a 7% cap in the second year over the prior year's expenses.

A compound CAM Cap refers to a CAM Cap that increases in a manner similar to compound interest, a 5% cap for the first year applies, and increases to 5.25% for the second year of its application.

To avoid the potential harshness of CAM Caps over the life of a long lease, Landlords often are able to negotiate a reset of the CAM Cap at the beginning of a certain specified year during the initial term (e.g. during the 10th calendar year of the term), when any options are exercised, or some combination thereof. An example of such a re-set clause is set forth below:

> Following the first full calendar year after the Commencement Date, Tenant's share of Common Area Costs for each ensuing twelve (12) month period thereafter, to the extent that the amount of such expenses are within

Landlord's reasonable control (as specified below) ("Controllable Common Area Costs"), shall not increase by more than five percent (5%) per annum (the "Cap") over the amount of Tenant's share of Controllable Common Area Costs for the previous twelve (12) month period (determined on a cumulative basis). Notwithstanding the foregoing, after every five (5) full calendar years following the Commencement Date, Tenant's share of Controllable Common Area Costs for the next ensuing calendar year (the "Re-Set Year") shall not be subject to the Cap, but shall be based on actual Common Area Costs. After such re-set of Common Area Costs to actual Common Area Costs, Tenant's share of Controllable Common Area Costs shall again be subject to the Cap for the next five (5) calendar year thereafter until the next Re-Set Year. This method of calculating Tenant's share of Controllable Common Area Costs shall continue for the remainder of the term.

3. <u>Uncontrollable Common Area Costs</u>. There are admittedly certain costs that a landlord simply cannot control. For example, a landlord cannot control how often (or how much) it snows in a particular winter season and, therefore, costs related to snow removal are generally always excluded from controllable costs. Other costs that are generally agreed in the industry as being uncontrollable are insurance premiums, costs of security, and utilities. A landlord would also be well-advised to try to exclude permitted capital expenses from any CAM Cap.

F. <u>Fixed CAMs</u>. On rare occasion, a lease will provide for fixed common area costs and, typically, fixed increases from one year to another. These are a bit of a "gamble" for each side given that in all likelihood, someone will win (at least a little bit) and someone will lose (at least a little bit). But, this allows for very simple and easy lease language as well as crisp and clean financial projections and budgeting. It is not uncommon for such fixed CAM payments to increase over time based on CPI increases and/or an agreed upon periodic percentage increases.

G. <u>Real Property Taxes and Insurance</u>. Real property taxes and insurance premiums are generally the other two "N's" in the "NNN." From a tenant's perspective, the items to address when including real estate taxes as a pass through charge are: (i) what portions of real estate taxes *won't* be passed through; and (ii) what happens if the landlord successfully appeals the taxes during, or even after, the term of the lease. Here are some examples of how a tenant can protect itself:

> Real Estate Taxes shall not include late payment penalties, fees or interest, nor the following taxes: income, excess profits, estate, single business, inheritance, succession, transfer, capital or other tax assessments upon Landlord or the Rent payable under this Lease.
>
> In the event any contest or appeal of the Real Estate Taxes for any given year shall result in a refund, abatement, reduction or credit of Real Estate Taxes previously paid by Tenant, Tenant will receive a credit against the next installment of Base Rent then due in the amount of Tenant's Proportionate Share of the net refund, abatement, reduction or credit, inclusive of any interest received by Landlord by reason of the refund, abatement, reduction or credit of Real Estate Taxes (i.e., the net amount remaining after paying all costs and expenses of securing the refund, abatement, reduction or credit, including reasonable attorney's fees). In the event Landlord receives such refund, abatement, reduction or credit after the Term or Tenant's share of such refund, abatement, reduction or credit exceeds Base Rent thereafter payable by Tenant for the remainder of the Term, Landlord shall promptly pay to Tenant Tenant's Proportionate Share of such refund, abatement, reduction or credit or the amount of such excess, as the case may be. Tenant's obligation to pay Real Estate Taxes shall in no event include penalties or interest imposed for late payment of Real Estate Taxes or late or non-filing of income and expense reports, unless attributable to Tenant's failure to pay Landlord same.

Negotiations usually revolve around what's included in the definition of taxes, such as, rent taxes, gross receipt taxes, assessments that pay for improvements made to or for the subject project or development, and, particularly in California, which party is responsible for increases in taxes caused by a sale of the project or development, as well as, to a lesser extent how the tenant's share of such taxes are calculated or otherwise paid.

IV. Office Lease Concepts. Operating expense concepts from office leases seem to be intruded more and more into retail leases as the years go by. With respect thereto, it is helpful to understand that in office leases common area square footage is allocated to individual tenant or occupant spaces for purposes of calculating the square footage therein, which area is often referred to as "rentable area." In some retail leases, landlords seek to allocate portions of certain common facilities, such utility rooms, to the tenants in the project in a manner similar to an office lease.

In other retail leases, landlords will seek an administrative fee based on a percentage of base or minimum rent. In office leasing, depending on the jurisdiction, it is common for tenant to pay administrative fees equal to 3 to 4 percent of base or minimum rent, or even base rent and additional rent.

When faced with such clauses, if a tenant is not able to negotiate more traditional common area cost provisions that it is comfortable with, a tenant should at least negotiate a most favored nation type clause, ensuring that all other tenants (or least those similar situated to the tenant in question) are paying for the applicable expenses in the same manner.

Some retail tenants are also asking for and in some instances entering into gross leases where the landlord pays for all of the common area and operating costs, except for utility charges incurred by the tenant and other minor carve-outs.

V. Audits. Many tenants request the right to audit the charges which the landlord attempts to pass on to the tenant and, when they do, the language typically provides for consequences if the audit reveals an overcharge by more than X%.

> Tenant may audit, inspect and copy the books and records of Landlord with respect to any cost or item which is passed through to Tenant upon 10 days advance, written notice by Tenant to Landlord. Landlord must cooperate with Tenant in providing Tenant reasonable access to its books and records during normal business hours for this purpose. If the results of the audit show an overcharge to Tenant of more than 3% of the actual amount owed by Tenant, then Landlord must pay the reasonable costs of such audit and, within 30 days of completion of such audit, Landlord must credit or refund to Tenant, at Tenant's election, any overcharge discovered by the audit, together with interest, at the rate of 12% per annum, accruing on the amount of the overcharge from the date payment was made by Tenant. If such audit discloses an undercharge to Tenant, Tenant must pay Landlord the amount of such undercharge within 30 days of completion of such audit.

Landlord requests regarding audit provisions typically center on limiting the period over which such audits may be conducted (e.g. in the range of 1 to 3 years after the subject year end statement is received), precluding audits being undertaken on a contingency fee basis and/or when the tenant is in default, and confidentiality requirements.

TENANT-ORIENTED CAM EXCLUSIONS PROVISION

Short form:

There shall be excluded from Common Area Charges (1) debt service under any mortgage of the Shopping Center; (2) rental payments under any ground or underlying lease of the Shopping Center; (3) Real Estate Taxes; (4) capital expenditures unless such capital expenditures are resulting from (x) Landlord's requirement to comply with then applicable laws, ordinances, rules, regulations and codes of any governmental or quasi-governmental authority or (y) such capital expenditures results in cost savings to the Common Area Maintenance Expenses; and in either such event except to the extent such item is amortized over its useful life as determined in accordance with generally accepted accounting principles (but in no event less than 10 years) and then only the amortized portion shall be included; (5) costs for which Landlord is reimbursed by its insurance carrier or any tenant's insurance carrier (but not excluding any reasonable deductibles not to exceed $5,000.00); (6) depreciation and amortization; (7) costs or expenses resulting from the violation of this Lease by Landlord, costs of repairing or correcting defects, latent or otherwise, in the Premises or Shopping Center; (8) costs associated with the operation of the business of the ownership or entity which constitutes Landlord or of which Landlord is a subsidiary, parent or partner, as distinguished from the costs of Shopping Center operations; (9) costs incurred to remove any hazardous materials from the Shopping Center (provided this clause shall not alter Landlord's and Tenant's responsibilities set forth elsewhere in the Lease); and (10) brokerage commissions and advertising expenses or any other costs incurred by Landlord in procuring new tenants.

"Killer" long form

Notwithstanding anything to the contrary contained herein, Common Area Charges shall not include (i) the cost of initially constructing and installing, or reconstructing and reinstalling, any portion or all of the Shopping Center, the Common Areas, or any expansion or replacement thereof; (ii) capital expenditures unless such capital expenditures are resulting from (x) Landlord's requirement to comply with then applicable laws, ordinances, rules, regulations and codes of any governmental or quasi-governmental authority or (y) such capital expenditures results in cost savings to the Common Area Maintenance Expenses; and in either such event except to the extent such item is amortized over its useful life as determined in accordance with generally accepted accounting principles (but in no event less than 10 years) and then only the amortized portion shall be included; (iii) any cost to repair a Common Area element incurred during the one (1) year construction warranty period following initial construction of such element; (iv) depreciation on any buildings or improvements related to the Shopping Center; (v) Interest, late charges, and penalties on any Operating Expenses; (vi) attorneys' fees and costs; (vii) the cost of any tenant improvements or other improvements, or other services or other Common Area costs, which are performed by or incurred by Landlord for the benefit of some, but not all, tenants of the Shopping Center; (viii) expenses for maintenance, repair and insurance of any outlot area that is separately maintained, insured, or paid for by the users of such outlot area; (ix) common Area costs that are self-insured (including retentions or deductibles) or are reimbursed by insurance proceeds (or would have been so reimbursed had Landlord maintained full replacement cost insurance) and/or condemnation awards; (x) any and all expenses incurred in procuring, retaining, negotiating, amending, extending, administering, or terminating leases with any existing or prospective tenants, including advertising, brokerage, architectural, engineering, and legal fees; (xi) any amounts payable under mortgages, deeds of trust, or ground leases encumbering all or any part of the Shopping Center; (xii) any costs or expenses incurred by Landlord in securing any governmental approvals to construct or operate the Shopping Center, whether pursuant to a development agreement or otherwise, including any impact fees, development fees, dedications, or other fees or charges paid to any governmental authority in connection with any such construction or operation; (xiii) any costs and expenses of investigating, removing, maintaining or monitoring any Hazardous Material (as defined in Section ___ hereof), or any costs and expenses of complying with Laws; (xiv) costs attributable to enforcing leases against tenants in the Shopping Center, such as attorney's fees, court costs, adverse judgments, and similar expenses; (xv) costs that are reimbursable to Landlord by tenants as a result of provisions contained in their specific lease, such as excessive use of utilities; (xvi) costs incurred due to violations of any of the terms and conditions of any leases in the Shopping Center; (xvii) management fees, administrative costs, on-site personnel, overhead and/or profit (combined) in excess of four percent (4%) of total Base Rent paid by tenants of the Shopping Center during the subject calendar year; (xviii) any compensation paid to clerks, attendants or other persons in commercial concessions operated by Landlord; (xix) rentals and other related expenses incurred in leasing air conditioning systems, elevators, or other equipment ordinarily considered to be of a capital nature; (xx) advertising and promotional expenditures, including wages and salaries of persons managing or administering such expenditures; (xxi) costs incurred in operating and maintaining the Shopping Center's parking facilities if Landlord charges for parking; (xxii) wages, salaries or other compensation paid to any employee above the grade of building manager; (xxiii) the cost of correcting any violations of Laws; (xxiv) costs attributable to repairing or replacing items that are covered by warranties; (xxv) any costs attributable to holiday decorations; (xxvi) the cost or rental value of vacant space in the Shopping Center, or space provided for maintenance, management, administrative, or security functions; (xxvii) any charges that duplicate other charges payable or monies due from Tenant hereunder; (xxviii) any cost item in a calendar year that was not a cost item in the year that the Rent Commencement Date occurs; (xxix) any costs related to Landlord's providing common trash removal service to any tenant(s) in the Shopping Center (provided Tenant is supplying and paying for its own trash removal service separate from other tenants in the Shopping Center); (xxx) any expense(s)related to the defense of Landlord's title to the Property; (xxxi) any charges or fees, including any administrative and/or management fees, related to or associated with Landlord's insurance coverage and/or Real Property Taxes (which are addressed separately in Section ___ and Section ___, respectively, herein); (xxxii) any costs to correct original or latent defects in the design, construction or equipment of the Building and/or Shopping Center; and (xxxiii) any charitable, lobbying, special interest or political contributions.

LANDLORD-ORIENTED CAM AND CAM EXCLUSIONS PROVISION

7.1 Common Area Expenses.

(a) The term "**Common Area Expenses**", as used in this Lease, shall mean all costs and expenses incurred by Landlord in (i) operating, managing, policing, insuring, repairing and maintaining the Common Area and the on-site management and/or security offices, nonprofit community buildings and child care centers, if any, as may be located in the Center from time to time, (ii) maintaining, repairing and replacing the exterior surface of exterior walls (and storefronts and storefront awnings if Landlord has elected to include the cleaning of same as part of Common Area maintenance) and maintaining, repairing and replacing roofs of the buildings from time to time constituting the Center, and (iii) operating, insuring, repairing, replacing and maintaining all utility facilities and systems including, without limitation, sanitary sewer lines and systems, fire protection lines and systems, security lines and systems and storm drainage lines and systems not exclusively serving the premises of any tenant or store ("**Common Utilities**"), Common Area furniture and equipment, seasonal and holiday decorations, promotional costs, Common Area lighting fixtures, Center sign monuments or pylons (but not the tenant identification signs thereon) and directional signage. Common Area Expenses shall include the actual costs incurred by Landlord for personnel (whether employees of Landlord or third party contractors) employed in the management and operation of the Center. Such personnel costs shall be proportionately allocated by Landlord in Landlord's sole yet reasonable discretion. Common Area Expenses shall include, without limitation, the following: expenses for maintenance, landscaping, repaving, resurfacing, repairs, replacements, painting, lighting, cleaning, trash removal, security, management offices, non-refundable contributions toward reserves for replacements, maintenance and/or repairs such as, but not limited to, major parking lot and parking garage repairs and repainting of buildings, fire protection and similar items; depreciation or rental on equipment; charges, surcharges and other levies related to the requirements of any Federal, state or local governmental agency; expenses related to the Common Utilities; Taxes on the improvements and land comprising the Common Area; rental loss insurance; comprehensive or commercial general liability insurance on the Common Area; insurance deductibles; reserves for insurance deductibles; maintenance and repair of grease interceptors (provided, however, Landlord shall have the right to allocate such costs to the tenants utilizing such grease interceptors); standard "all risks" fire and extended coverage insurance with, at Landlord's option, earthquake, flood and/or terrorism damage endorsements covering the Common Areas; the Center's share of the costs incurred to operate, manage, insure, maintain, repair and replace those common areas (and related facilities) utilized by the Center and the properties adjacent to and surrounding the Center pursuant to the terms of the any Declaration and any other Recorded Documents; costs of management of the Center (whether such management services are provided by Landlord or a third party contractor); and a sum (the "**Administration Fee**") payable to Landlord for administration and overhead in an amount equal to fifteen percent (15%) of the Common Area Expenses. In addition to any reserves as set forth above, Common Area Expenses shall specifically include capital expenditures, repairs, improvements, and replacements including, without limitation, amortization of such capital items over their useful lives (with an interest factor reasonably determined by Landlord), each of which useful life shall be reasonably determined by Landlord (provided, however, if Tenant's share of the cost of the capital expenditure would not exceed four percent (4%) of its Minimum Base Rent for the calendar year in question, Landlord shall not be obligated to amortize such capital expenditure).

(b) Notwithstanding anything contained in Section 7.1(a), Common Area Expenses shall not include (i) the cost of providing or performing improvements, work or repairs to or within the premises of another tenant or occupant of the Center where such improvements are of a nature which are not Landlord's responsibility to perform pursuant to this Lease, except where Landlord may do such improvements, work or repairs both to such other premises and to the Premises; (ii) any interest or principal payments on financing secured by a deed of trust or mortgage on the Center and rental under any ground or underlying lease or leases of the land on which the Center is constructed; (iii) legal and other fees, leasing commissions, advertising expenses and other costs incurred exclusively in connection with the leasing of the Center; (iv) any interest and penalties incurred as a result of Landlord's late payment of any bill; (v) any bad debt loss, rent loss or reserves for bad debt or rent loss; (vi) any items for which Landlord is reimbursed by insurance or otherwise compensated, to the extent of the net receipts from such insurance or compensation, including direct reimbursement by any tenant or occupant of the Center (exclusive of reimbursement pursuant to any provision in a lease or other occupancy agreement similar to this Section 6); (vii) costs attributable to enforcing leases against other tenants in the Center, such as attorneys' fees, court costs, adverse judgments and similar expenses; (viii) costs associated exclusively with the operation of the business of the entity which constitutes Landlord which are not directly related to the operation of the Center and which relate to the following: the formation of the entity which constitutes Landlord; the internal accounting and legal matters which relate exclusively to preparation of the tax returns and financial statements of such entity, together with the gathering of data therefor; the cost of defending any lawsuits with any mortgagee; the costs of selling, syndication, financing, mortgaging or hypothecating any of Landlord's interest in the real property and improvements constituting the Center; and the costs of any dispute between Landlord and any employee to the extent that the other costs attributable to the employment of such employee are not permitted to be included within Common Area Expenses pursuant to this Lease; (ix) costs of repair or restoration work following a casualty or condemnation, if and to the extent Landlord is reimbursed by insurance, or if and to the extent covered by the proceeds of any condemnation award actually received by Landlord; (x) depreciation on the buildings of the Center charged for financial or tax accounting purposes; and (xi) the portion of any fee or charge for services paid to a party owned by or under common ownership with Landlord to the extent that the same exceeds the competitive cost for such services were they not so rendered by a party affiliated with Landlord.

NEGOTIATED CAM EXCLUSIONS PROVISION

Notwithstanding the above, Common Area Expenses shall not include any Common Area Expense Exclusions. For purposes of this Lease, Common Area Expense Exclusions are as follows:

a. The cost of the original construction of the Center and cleanup of original construction or any additions or expansions to the Common Areas or the Center and other items which under generally accepted accounting principles are properly classified, or are customarily capitalized in the real industry, as capital expenditures of any kind except as specified above;

b. any repairs or work performed to any portion of the Center intended to be occupied by individual tenants, and the cost of correcting any defects in the original construction of the Center;

c. any reserves for future expenditures not yet incurred;

d. costs incurred by Landlord for repair or restoration to the extent that Landlord is reimbursed by insurance or condemnation proceeds or that the same is covered by warranty or Landlord’s insurance deductibles;

e. costs, including permit, license and inspection costs incurred with respect to the installation of improvements made for tenants or other occupants or incurred in renovating or otherwise improving, decorating, painting or redecorating vacant space for tenants or other occupants;

f. attorneys’ fees, leasing commissions and other costs and expenses incurred in connection with negotiations or disputes with present or prospective tenants or other occupants of the Center;

g. expenses in connection with services or benefits which are not offered to Tenant;

h. costs incurred by Landlord due to the negligence or misconduct of Landlord or its agents, contractors, licensees and employees or the violation by Landlord of the terms and conditions of another lease of space or other agreements including this Lease;

i. overhead and profit increment paid to Landlord or to subsidiaries or affiliates of Landlord for services to the extent the same materially exceeds the costs of such services rendered by other first-class unaffiliated third parties on a competitive basis;

j. interest, principal points and fees on debts or amortization on any mortgage or mortgages or any other debt instrument encumbering all or any portion of the Center or the real property upon which the Center is located;

k. any compensation paid to clerks, attendants or other persons in commercial concessions operated by Landlord;

l. all items and services (i) for which Tenant or any other tenant reimburses Landlord; or (ii) which Landlord provides exclusively to one or more tenants (other than Tenant);

m. advertising and promotional expenditures in connection with leasing the Center, and costs of the installation of signs identifying the owner and/or manager of the Center;

n. electric power costs for which any tenant or occupant directly contracts with the local public service company;

o. any costs relating to hazardous materials, asbestos and the like resulting from actions of Landlord, its employees or agents;

p. charitable contributions;

q. any charges for depreciation of the buildings of the Center or of equipment for the Center;

r. any charge for Landlord's income taxes, excess profit taxes, or franchise taxes;

s. the cost of any electric current or other utility furnished to any leasable area of the Center;

t. cell phones, pagers and the like;

u. marketing, promotions or advertising of any kind;

v. costs, including permit, license and inspection costs incurred with respect to the installation, maintenance or otherwise associated with pylon or other signage utilized by tenants or other occupants or incurred in renovating or otherwise improving, maintaining, painting or other costs associated with pylon or other signage for tenants or other occupants on which Tenant does not appear; and

w. there shall be no duplication in charges to Tenant by reason of the provision in this Lease setting forth Tenant's obligation to reimburse Landlord for Common Area Expenses and any other provision herein.