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Peer to Peer 6

**CAM Costs & Audits: Administrative Horror Stories of Lawyers Negotiating CAM - What's Practical
& What is Not**

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NEGOTIATING CAM COSTS IN RETAIL LEASES

TYPICAL RETAIL RENT STRUCTURES

Net - In a net lease, the tenant pays for pass-through costs as additional rent. This is accomplished by the tenant either: (i) directly paying for these costs (typically when the tenant leases an entire building), or (ii) paying the landlord for its proportionate share of these costs based on the square footage leased by the tenant in relation to the building, center, or portion thereof (as applicable). In this rent structure, the tenant bears the risk of increases in additional rent costs.

Retail leases are usually net leases where the tenant pays its proportionate share of common area costs, real estate taxes, and the landlord's insurance costs. The tenant may also pay percentage rent, a marketing charge, and/or other charges.

Modified Gross - A modified gross lease is a combination of the net and gross structures where some pass-through expenses are included in the tenant's base rent payment, while others are paid in addition to base rent. For example, the tenant may have to pay additional rent only for its proportionate share of taxes. In this rent structure, the parties share some of the risk of increases in additional rent costs.

Gross - In a gross lease, pass-through expenses are included in the tenant's base rent payment, and the tenant pays no additional rent beyond base rent. In this rent structure, the landlord bears the risk of increases in additional rent costs.

TYPICAL METHODS OF CALCULATING COMMON AREA COSTS

Proportionate Share – The tenant pays its “share” of common area costs, determined by the following fraction:

Numerator: The leasable square footage of the premises leased by tenant, calculated using the agreed-upon measurement standard (typically BOMA).

Denominator: The leased or leasable square footage of the building, center, or portion thereof (as applicable). The landlord also typically excludes anchor tenants and kiosks, and any occupant who self-maintains the applicable common areas from the denominator.

Fixed CAM – The tenant pays a fixed charge for common area costs that is not dependent on the landlord's actual costs, with periodic fixed increases. Fixed CAM provides certainty for the tenant; however, the landlord bears the risk that the actual common area costs exceed the Fixed CAM costs. Additionally, Fixed CAM costs avoid: (i) having to negotiate exceptions to common area costs; (ii) calculating the tenant's proportionate share (as to common area costs); (iii) the tenant's need to audit the landlord's books (as to common area costs); and (iv) year-end reconciliations (as to common area costs).

NOTE: The landlord should attempt to exclude uncontrollable amounts (such as snow removal and utilities) from Fixed CAM. Fixed CAM is analogous to a cap on common area costs; however, unlike a CAM cap [described below], the increase is automatic and not tied to the actual common area costs (negating the administrative burden).

NOTE: The tenant's proportionate share of taxes and insurance costs are not typically included in Fixed CAM because they are outside of the landlord's control.

DEFINING COMMON AREA COSTS; EXCLUSIONS

If the tenant is paying its proportionate share of common area costs, then retail leases usually include a detailed definition of common area costs and specifically list what common area costs the landlord can pass through to the tenant. From the landlord's perspective, all costs relating to owning, operating, and maintaining the common areas should be passed directly through to the tenant.

CAM Exclusions – From the tenant's perspective, certain common area costs should not be passed through to the tenant, because the tenant does not directly benefit from these costs. Therefore, in response to the broad list requested by the landlord, the tenant will typically identify certain items that cannot be passed through.

Three of the most commonly negotiated common area costs exceptions are:

Maintenance of Structural & Exterior Portions of the Improvements: Landlords typically pass-through the cost of maintaining the exterior, structural elements of the shopping center buildings (e.g., roof, membrane, canopies, downspouts, beams, bracing, risers, ceiling, support, walls, stucco, windows, doors, foundation and floor slab). Tenants push back on this inclusion, arguing that only items that are “shared in common” should be included in common area costs, and that these exterior, structural elements of the shopping center are a part of the premises and are included in the rent for that premises.

Administrative and/or Management Fees: Landlords often charge their tenants for administrative and management fees. The management fee is typically payable to management company (affiliated or not) for overseeing the on-site operations of the property, such as lease administration and property management, and is generally a percentage of rents/revenue. The administrative fee typically reimburses the landlord for costs incurred by the other corporate support departments (which are not included in the management fee), such as risk management, legal, and corporate accounting, and is generally a percentage of all costs. Many tenants feel that a management fee, in addition to the administrative fee, is “double dipping” – as they are essentially paying for the same thing. If both fees are charged, a compromise is to clarify that the administrative fee is not assessed on the management fee. An additional compromise is to exclude items from the calculation of the administrative fee that require low administrative oversight – such as utility charges or insurance.

Capital Expenditures: Capital expenditures generally fall into three categories: (1) capital improvements (additions or “betterments”); (2) capital replacements (replacement of existing capital assets); and (3) capital repairs (significant repairs that rise to the equivalent of capital replacements). Tenants believe capital improvements are an investment of the landlord in the property, and are not an operating cost that should be passed through to tenant. Furthermore, tenants contend that base rent is designed to compensate the landlord for capital repairs and replacements, so reimbursement for these costs is “double dipping.” Landlords may not have priced the base rent in this manner, and want to pass-through all capital expenditures, just like all other costs, to make this a net lease. The parties typically compromise that capital expenditures are permissible, provided they are amortized over their useful life [subject to other limitations, such as how often capital replacements like a roof or parking lot can be completed]. The tenant should agree to pay for a portion of the landlord’s capital expenditures if they: (i) are required by law; or (ii) result in a material increase in the efficiency of the building or its systems.

RECONCILIATIONS

If the tenant is paying its proportionate share of common area costs, the lease will provide that the tenant pay an estimated amount of common area costs for that year. As such costs are an estimate, the lease should provide for a reconciliation of such CAM costs on an annual basis, whereby any overpayment by the tenant will be credited, and any underpayment due to the landlord. The tenant will require this reconciliation to be provided within a specified period of time (such as 30-120 days after year-end), whereas the landlord does not want to be obligated to provide such reconciliation within a certain time period (or else, the landlord could be in default).

If the landlord fails to timely provide the reconciliation, the tenant may demand that no estimates for the following year are due and payable; however, a more equitable remedy would be for tenant to continue paying the prior year’s estimates.

The tenant may also seek an outside date for common area costs where, if the landlord fails to timely submit a reconciliation or additional bill, those charges are waived. If the landlord is agreeable to this concept, the timeframe should give sufficient time for the charges to be billed (e.g., 2 years), and calculated from the date such charge was to be billed (e.g., the due date for reconciliations for that charge). Furthermore, any waiver in connection with reconciliations should be limited to the increase that could have been charged based upon such reconciliation (as opposed to waiving the charges, which could result in the estimated amounts paid becoming a credit). The landlord should make this mutual – so that the tenant similarly waives any credit owed.

CAM AUDIT

The tenant may seek the right to audit Landlord's books and records in connection with common area costs to determine the accuracy of Landlord's reconciliation statement. It is market to give an audit right for common area costs, if the tenant is paying its proportionate share of the common area costs; however, it is not market to give an audit right if there is Fixed CAM. If a CAM cap is given, audit rights are less likely to be granted by the landlord;

however, tenants will claim that the landlord has an incentive to drive up common area costs up to the CAM cap, thereby still requiring the need for the right to audit.

Typical considerations when giving an audit right:

Reimbursement: If the audit reveals that the landlord has overcharged common area costs, then the tenant will seek reimbursement of the costs of the audit. The landlord will typically agree to reimbursement of such audit costs, if such overcharged amount meets a certain threshold, and cap the amount of such reimbursement.

Auditor: The landlord will preclude an auditor on a “contingency fee” basis because such auditors tend to be overly aggressive.

Confidentiality: The results of the audit should be confidential.

CAM CAPS

The tenant will often try to reduce their risk of increases on common area costs increase by negotiating a cap on the common area costs. Some examples of CAM caps are as follows:

Cap on First Year Charges - Caps the amount payable by tenant for the first year of the term.

Ongoing Cap on Tenant’s Proportionate Share - Caps how much the tenant’s proportionate share may increase over subsequent years.

NOTE: This method of capping common area costs has unintended consequences, since removing square footage from the denominator would result in an increase in this tenant’s proportionate share, even if the amount of common area costs did not increase.

Ongoing Cap on Increases - Caps how much amount payable by tenant may increase after the first year of the term.

NOTE: When a CAM cap is given, the CAM cap should apply only to controllable expenses, and any uncontrollable expenses should be excluded (such as snow removal and utilities). The landlord should also consider resetting the CAM cap upon the exercise of any renewal, to ensure that the CAM cap is not too tenant-favorable.

NOTE: The tenant’s proportionate share of taxes and insurance costs are not typically capped because they are outside of the landlord’s control.

Generally speaking, CAM caps in retail leases tend to either be cumulative or non-cumulative:

Cumulative Cap: This is landlord-preferred. A cumulative cap allows the landlord to carry over unused permitted increases to subsequent years. The tenant bears the risk of any increases within the CAM cap (with any unused permitted increases carried forward to subsequent years) during the applicable period, and the landlord bears the risk of any increases higher than the CAM cap (with any unused permitted increases carried forward to subsequent years) during the applicable period.

Non-Cumulative Cap: This is tenant-preferred. A non-cumulative cap is only applicable for that applicable period, with no carry-over of unused permitted increases; therefore, a year that has substantially lower common area costs will lower CAM caps for the following year. The tenant bears the risk of any increases within the CAM cap during the applicable period, and the landlord bears the risk of any increases higher than the CAM cap during the applicable period.

**HYPOTHETICAL
PART 1:**

You represent the landlord and have been engaged by your client to negotiate a lease agreement with a small, non-national tenant for in-line retail space at their shopping center. The landlord has provided you with a fully executed letter of intent, which states the following regarding common area maintenance ("CAM") costs:

CAM Costs: \$10.00 psf, estimated. 5% cap on CAM. To be further described in the lease.

The landlord advises there was no further discussion beyond what was in the letter intent for CAM costs. The lease is to be on the landlord's standard lease form.

QUESTION NO. 1: As landlord's counsel, what is your high-level goal for the CAM costs provision?

QUESTION NO. 2: As the landlord's counsel, with that high-level goal in mind, what is your interpretation of the business deal? What is included in the CAM costs provision? What is excluded or left silent? Why?

PART 2:

You represent the tenant in the negotiation of the lease above. You have received the landlord's preliminary draft of lease with the following CAM costs provision:

Commencing on the Rent Commencement Date and for the duration of the Term, Tenant shall pay Tenant's Share of Common Area Costs (defined below) incurred in the operation of the Shopping Center for each calendar year; provided, however, during the initial Term, Tenant's Share of Common Area Costs (excluding Uncontrollable Costs [defined below]) in any calendar year shall not increase by more than a five percent (5%), over Tenant's Share of Common Area Costs for the immediately preceding calendar year, calculated on a compounded cumulative basis (the "CAM Cap"). If Tenant elects to extend or renew the Term beyond the initial Term, then Tenant's Share of Common Area Costs for the first year of any such extension or renewal term shall not be subject to the CAM Cap; however, each subsequent calendar year of each such extension or renewal term shall be subject to the CAM Cap.

"Common Area Costs" shall mean all costs and expenses necessary to own, operate, and maintain the Shopping Center and all Common Areas (including, but not limited to, utilities, repairs and improvements (including capital improvements), painting, trash and snow/ice removal, repaving, resurfacing, re-striping landscaping and lawn maintenance, sign installation and maintenance, together with any administrative and/or management fees). "Uncontrollable Costs" shall mean those Common Area Costs that, in Landlord's sole and exclusive discretion and judgment, may be subject to increases that are outside Landlord's control, including, but not limited to, Common Area Costs related to: (i) insurance; (ii) utilities; (iii) security; (iv) Taxes; (v) snow and ice removal; and (vi) compliance with laws.

QUESTION NO. 1: As tenant's counsel, what is your high-level goal for the CAM costs provision?

QUESTION NO. 2: As the tenant's counsel, with that high-level goal in mind, what is your interpretation of the deal? What do you add to the CAM costs provision? What do you remove? Why?

PART 3:

In response, the tenant's counsel makes the following revisions to the CAM costs provision:

Commencing on the Rent Commencement Date and for the duration of the Term, Tenant shall pay Tenant's Share of Common Area Costs (defined below) incurred in the operation of the Shopping Center for each calendar year; provided, however, during the first full calendar year (12 months) of the initial Term, Tenant's Share of Common Area Costs shall not exceed \$10.00 per square foot, and during the entire Term (including any extensions or renewals thereof), Tenant's Share of Common Area Costs (excluding Uncontrollable Costs [defined below]) in any calendar year shall not increase by more than a five percent (5%), over Tenant's Share of Common Area Costs for the immediately preceding calendar year, calculated on a non-cumulative basis (the "CAM Cap").

Notwithstanding anything to the contrary set forth in this Lease, in no event shall Tenant's Share exceed _____ percent (_____%). [NTD: LANDLORD TO PROVIDE CURRENT AMOUNT OF TENANT'S SHARE]

"Common Area Costs" shall mean all costs and expenses necessary to own, operate, and maintain the Shopping Center and all Common Areas (including, but not limited to, utilities, repairs and improvements (including capital improvements), painting, trash and snow/ice removal, repaving, resurfacing, re-stripping landscaping and lawn maintenance, sign installation and maintenance, together with any administrative and/or management fees), except as expressly set forth below. "Uncontrollable Costs" shall mean those actual, reasonable Common Area Costs (as limited below), consistent with those incurred in other first-class shopping centers, related to: (i) insurance; (ii) utilities; (iii) security; (iv) Taxes; and (v) snow and ice removal.

Notwithstanding the foregoing, the following shall not constitute Common Area Costs: (i) costs of correcting defects in the initial construction of the Shopping Center, provided that this shall not exclude the cost of normal repair and maintenance (but not replacement) expected with respect to the construction materials and equipment installed in the Shopping Center; (ii) wages, salaries, compensation and benefits of any employees above the level of property manager; (iii) fines, interest, charges, penalties, damages and other costs incurred by Landlord by reason of any default (or claim of default) or late payment by it under any lease or other contract or instrument (regardless of whether or not the payment itself is allowed to be included in Common Area Costs), including, without limitation, any legal and other professional fees paid or incurred in connection therewith; (iv) any costs (unless such costs would otherwise have been incurred by Landlord in the normal course of maintenance and repair and which are not otherwise excluded by the terms of this Section), including penalties and fees, incurred because of a violation, or responding to a potential violation, by Landlord or any tenant or occupant of the building of any applicable laws including, without limitation, any applicable ordinance of the city or county pertaining to the installation/retrofit of fire sprinklers in the Shopping Center or the terms and conditions of this Lease or of any other lease, contract, easement, license, encumbrance or other obligation or agreement relating to the Shopping Center; (v) any costs incurred in the event any portion of the Shopping Center is made untenable by fire, earthquake, or other casualty or by exercise of the rights, of eminent domain or other cause, or to perform repairs or other work occasioned by loss or damage from casualty or the exercise of the rights of eminent domain, no matter whether paid for by insurance or condemnation proceeds; provided that a reasonable deductible may be included within Common Area Costs; (vi) damage and repairs or any other costs necessitated by the negligence or willful misconduct of Landlord, or any of its employees, agents, vendors, contractors, or providers of materials or services; (vii) wages, salaries, and benefits paid to Shopping Center personnel to the extent of time such personnel are not directly working on the management, operation, administration, repair or maintenance of the Shopping Center, including the cost of pension plans, fringe benefits, medical insurance, group life and disability insurance, general welfare benefits, union contributions, payroll taxes and other related expenses in connection with the persons identified above; (viii) legal fees, accounting fees, professional expenses, and other related costs except those incurred in connection with the management, maintenance, operation, and repair of the Shopping Center and expressly excluding such fees and costs incurred in connection with proposals, negotiations, or disputes with tenants or other occupants of the Building or prospective tenants or occupants of the Building or associated with the enforcement of the terms of any lease (including unlawful detainer proceedings or proceedings for the collection of rent), requests to assign or sublet or the defense of Landlord's title to or interest in the Shopping Center or any part

thereof, and the sale, transfer, financing, or refinancing of the Shopping Center; (ix) any ground lease rental; (x) depreciation on the Shopping Center or any Shopping Center components, systems, or equipment, (s) all items and services for which Tenant directly reimburses Landlord; (xi) all services that are not offered by Landlord to all tenants hereunder or which Landlord provides selectively to one or more tenants or occupants of the Shopping Center that are not customary for normal Shopping Center use; (xii) any amounts owed by Landlord to other tenants and all costs incurred which are subject to direct reimbursement (or are reimbursed) by other tenants of the Shopping Center or other parties, including expenses for repair or replacement paid by proceeds of insurance in connection with any insurance (carried by Landlord, other tenants or by anyone else), through condemnation awards or by warranty claims; (xiii) Landlord's general corporate or partnership overhead and general and administrative expense and costs associated with the operation of the business of the partnerships or other entities that constitutes Landlord, as distinguished from the costs of the management, operation, repair and maintenance of the Shopping Center, including, without limitation, accounting and legal costs, costs of defending lawsuits with any mortgagee, costs of selling, syndicating, financing, mortgaging, or hypothecating any ownership interest in Landlord or any of Landlord's interest in the Shopping Center and costs incurred in connection with any disputes between Landlord and its partners, between Landlord and its employees (and not reasonably related to the operation and management of the Shopping Center (disputes which would be so reasonably related would include minor disputes in the normal course of its operation and management of the Shopping Center, but would not include, for example, sexual harassment, discrimination or wrongful termination claims)), between Landlord and any other owner of an interest in the Shopping Center, between constituent partners of Landlord, between Landlord and building management, or between Landlord and other tenants or occupants; (xiv) Any compensation paid to clerks, attendants, or other persons in commercial concessions operated or subsidized by Landlord or operated by others in the Shopping Center; (xv) rentals and other related expense incurred in leasing air-conditioning systems, elevators, or other equipment ordinarily considered to be of a capital nature, except (a) When such equipment is rented for purposes of making repairs or keeping permanent systems in operation while repairs are being made; and (b) equipment not affixed to the Building that is used in providing janitorial or similar services; (xvi) advertising and promotional expenditures and costs of acquisition and maintenance of signs in or on the Shopping Center identifying the owner of the Shopping Center or other exterior signage granted to other tenants of the Shopping Center; (xvii) costs arising from Landlord's charitable or political contributions; (xviii) costs for the acquisition of sculpture, paintings, or other objects of fine art; (xix) any bad debt loss, rent loss, or any reserves, including reserves for capital items, bad debts or rental losses, or for future Common Area Costs or Taxes; (xx) amounts paid to Landlord, or to subsidiaries of Landlord for goods and/or services furnished for the Shopping Center to the extent the same exceeds the costs of such goods and/or services by unaffiliated third parties on a competitive basis; (xxi) any utility costs for which any tenant or occupant of the Building directly contracts with the local public utility company; (xxii) any travel and entertainment expenses of Landlord, any management agent of Landlord, and their respective employees, agents, and affiliates; (xxiii) costs incurred by Landlord in connection with any audit of Common Area Costs and/or Taxes initiated or requested by a tenant of the Shopping Center other than Tenant; (xxiv) any costs incurred in connection with any major change or alteration in the Shopping Center, or any portion thereof, such as adding or deleting floors; (xxv) any cost, interest, or tax penalties incurred as a result of Landlord's negligence, inability, or unwillingness to make tax payments (or to file tax filings or returns) when due; (xxvi) any costs relating to the actual, alleged, or threatened, presence, storage, removal, remediation, investigation, maintenance, containment, or treatment of any substance identified as a hazardous materials in, on, about, under or adjacent to the Shopping Center, including without limitation, in connection with any effort to comply with any law; (xxvii) any costs with respect to the implementation or installation of any improvements, corrections, repairs, or replacements of structural elements of the Shopping Center or any seismic safety, retrofit, or enhancement program or any costs of repair, replacement, or correction of defects relating to any tenant or other improvements in the Shopping Center; (xxviii) any costs, fees, dues, contributions, or similar expenses for industry associations or similar organizations; (xxix) any costs incurred in removing and storing the property of former tenants or occupants of the building; (xxx) any costs, expenses, assessments, fees, and other payments pertaining or relating to any future development or redevelopment of the Shopping Center (including, without limitation, any of the same which would not be incurred, paid or payable if the Shopping Center were not further developed or redeveloped); (xxxi) any costs of any parties, ceremonies, or other events for tenants, Landlord, or third parties which are not tenants of the building; (xxxii) any direct or indirect costs incurred in connection with the ownership, operation, management, maintenance, and repair

of the garage (other than costs relating to taxes and insurance, and the costs of maintaining and repairing those areas of the garage if any, used to house building systems such as the chillers and pumphooms and emergency lighting); (xxxiii) Any costs of installing, operating, and maintaining any other service operated or supplied by, or normally operated or supplied by, a third party under an agreement between a third party and a landlord which service is normally supplied by a landlord or such third party in comparable buildings; and (xxxiv) costs incurred by Landlord in connection with rooftop communications equipment of Landlord or other persons, tenants, or occupants of the building, unless required by law or for safety purposes or costs relating to equipment for all of the tenants of the building.

QUESTION NO. 1: As the landlord's counsel, what items do you focus on to achieve your high-level goal? Why?

QUESTION NO. 2: As the tenant's counsel, what items do you focus on to achieve your high-level goal? Why?

QUESTION NO. 3: What items tend to be heavily negotiated? What items seem to be "settled" as market?

PART 4:

The parties have agreed to the CAM costs provision, and the lease has been executed. The CAM costs provision contains the following concepts:

1. A list of exclusions from the Common Area Costs that materially differ from both the landlord's and the tenant's standard lists.
2. A ceiling on the first full calendar year of Common Area Costs.
3. A 5% cumulative CAM cap for each calendar year thereafter.
4. Timing limitations on pass-throughs for capital improvements (e.g., 7 years for parking lot improvements).
5. A 120-day deadline after the first of each calendar year for the landlord to submit annual reconciliations for Common Area Costs.
6. An annual right for the tenant to audit the Common Area Costs.
7. Resets on the CAM Cap for each renewal or extension term, if exercised.

QUESTION NO. 1: What administrative concerns are created for the landlord? How does the landlord protect itself?

QUESTION NO. 2: What administrative concerns are created for the tenant? How does the tenant protect itself?

PART 5:

Going back in time - you are general counsel for the client. The letter of intent is being negotiated, so you have the opportunity to be involved in how the parties structure the deal.

QUESTION NO. 1: As the landlord's general counsel, returning to the high-level goal, how could the letter of intent be drafted to better memorialize the deal and that goal?

QUESTION NO. 2: As the tenant's general counsel, returning to the high-level goal, how could the letter of intent be drafted to better memorialize the deal and that goal?

QUESTION NO. 3: We all know that, even if the letter of intent perfectly captures the landlord's or the tenant's goal – there is still likely to be ambiguity on one side, with necessary negotiations. Is there a better way to structure how CAM costs are calculated, passed-through, and/or managed to avoid this friction? What kinds of solutions have you used in the past to get deals over the finish line?