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Workshop 12

Advanced CAM Issues: CAM We All Just Get Along?

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Common area maintenance (or "CAM") is a critical component of both the shopping center landlord and tenant's economic outlook for any location. For landlords, the concern is two-fold: ensuring that CAM costs are narrowly tailored to the quality and amenities offered by a shopping center and ensuring that shopping center tenants reimburse to the landlord as much of CAM costs as possible. For tenants, the goal is meeting expectations and preventing surprises: if the annual CAM costs meet the initial business proforma and/or increase in a consistent manner, then the tenant can focus on meeting customers needs, growing sales and increasing profit. Unsurprisingly, given the consequences of missing the mark on CAM for either party, it is paramount that the lease language governing CAM – exclusions and inclusions, pro rata share, capping provisions and audit rights – be drafted clearly, concisely and fairly.

I. What is CAM? What Isn't (or Shouldn't Be) CAM?

CAM[1] is a collection of expenses incurred by a shopping center owner in order to repair, maintain and replace the common areas of the shopping center. These expenses commonly include the following: utilities (including lighting), cleaning, sweeping; trash removal; repainting the exterior painted portions of the shopping center; snow and ice removal; restriping; landscape maintenance; the employment of personnel (including security); and an administration fee (usually in an amount equal to 10-15% of the CAM costs).

CAM is usually paid by tenants as additional rent, together with other forms of additional rent such as insurance premiums and real estate taxes. For the first lease year, tenants usually pay an estimated amount[2] of CAM; after the first lease year, landlords will provide tenants with a reconciliation statement, pursuant to which (if CAM for the previous lease year exceeded the estimate) tenant will reimburse landlord the difference or (if CAM for the previous lease year was less than the estimate) landlord will credit tenant the difference. Meanwhile, landlords have typically provided tenants with an estimate for the following lease year's CAM, and the process repeats itself.

The goal for landlords is to include as many of the expenses in the nature of common area or shopping center maintenance within CAM; many retail leases will not contain any carve-outs to the definition of CAM – such leases will permit landlords to include, in addition to any specific list, "any other expenses reasonably incurred by Landlord in repairing, replacing and maintain the Shopping Center". In circumstances such as these, tenants must put a significant amount of trust in landlords to not use CAM as a vehicle for unscrupulous purchases or large unplanned expenses, because landlords that do not have parameters around what can be included in CAM can make the argument that nearly any purchase for the shopping center could be CAM.

Wise tenants should request (if not demand) a list of costs and expenses that should be expressly excluded in the list from CAM. Typical exclusions fall into several categories: such costs (e.g., insurance premiums or real estate taxes) are addressed in other parts of the lease; costs (such as advertising the shopping center and holiday decorations, sculpture and artwork) related to marketing the shopping center that are duplicative of or redundant to tenant's own efforts; costs (e.g., commissions or brokerage fees or tenant-specific utilities) related to other tenant's leases or spaces; costs (e.g.; executive or managerial salaries, consulting fees, fees paid to accountants, architects, engineers, attorneys or other professionals, home branch office expenses, costs relating to a sale or refinance of the shopping center, including increased taxes resulting therefrom, or market study fees) relating to landlord's overhead or business; costs (initial development, initial paving, initial striping or initial landscaping costs) relating to the initial development of the shopping center, which tenant does not (directly) benefit from; capital expenditures (although tenant can and should agree to intermittent paving or repainting of the shopping center, provided such

[1] CAM can be distinguished from "operating expenses", which is a concept found in office leasing. Office buildings have a significant amount of space that is neither tenant space, nor common area space: space such as elevator shafts, data closets, security and staff areas, leasing offices, roof space, and the like. Landlords attempt to pass along costs associated with all of those areas, none of which would constitute "common area maintenance" in the common understanding of the term. In shopping centers, on the other hand, the predominant category of costs incurred by landlords (even for enclosed shopping malls) relate to common areas – hence why retail leases speak of "common area costs" rather than "operating expenses".

[2] Large credit tenants can often convince landlords to cap CAM costs in the first lease year, in addition to capping future years' CAM costs as hereinafter discussed.

costs are appropriately amortized); costs arising from landlord's negligence or default or penalties from late payments of any kind; any costs arising from shopping center defects or other items covered by insurance reimbursements or warranty payments; ground rent, because otherwise would permit landlord a double recovery of rent; costs of environmental remediation (if caused by tenant, those costs would be addressed in a different portion of the lease); or any costs paid to contractors or vendors that are above market.

Landlords (especially large landlords) can and will balk at a long list of CAM exclusions – for each CAM cost that landlords cannot recover, profit from the shopping center is reduced. That said, tenants have good reason to request all or any of the foregoing listed costs. Exclusions serve as a check on landlords and incentivize them to operate and manage the shopping center in an efficient and fair manner.

II. **Paying the Right Percentage of CAM**

That tenant should only pay tenant's pro rata share of all CAM incurred for a shopping center should be a concept familiar to most leasing attorneys. However, there are several interstitial concepts negotiated by landlord and tenants in retail leases.

A. Setting the Denominator.

Shopping centers are constructed in a variety of styles and configurations: enclosed shopping malls, power centers, inline shopping centers, with landlord-owned outlot buildings, with third-party owned landlord buildings, with anchor tenants who own their own land – the list goes on. For each of these varieties, landlords and tenants should be alert to determining the correct denominator to use for the purposes of calculating tenant's pro rata share in the lease.

For example, imagine a power center with: an inline building containing a range of retail boxes sized from 2,500 to 25,000 in gross floor area ("GFA"); several outlots owned by the landlord and leased to restaurants; one third-party owned outlot; and a large anchor tenant that owns its portion of the shopping center in fee. It would be incorrect to reflect the denominator for the pro rata share calculation as the GFA of all of the foregoing occupants: clearly, at a minimum, the large anchor tenant and the third-party owned outlot should be excluded.

But what about the landlord-owned outlots? In theory, because these outlots are leased to restaurant tenants, the leases are likely "triple-net" leases and the tenants themselves would be required to provide repair and maintenance of their lots. Although landlords may not be willing to share the leases for those tenants, attorneys for both tenants and landlords should inquire as to whether landlord actually provides any repair and maintenance to the outlots, and – if not – the GFA for the outlots should be excluded from the denominator of tenant's pro rata share. Tenant attorneys may be tempted in this specific context to not say anything, because an error would benefit their client; however, errors in this context benefit neither party, as the concept of tenant's pro rata share is intended to be fair to both parties.

Both parties should take care when calculating pro rata share to examine the shopping center site plan and the nature of development therein to ensure that landlord is receiving, and tenant is paying, the amount of CAM costs each party expects to and should pay under the lease.

B. Minimum GFA

Once the tenant's pro rata share is determined to be correct, tenants would be wise to limit landlords' ability to redevelop or reconstitute the shopping center in a manner that increases tenant's share of CAM. The hypothetical situation is as follows: a tenant signs a lease and enters into a shopping center expecting to pay for 10% of all CAM. Five years later, because of various tenant departures within the shopping center, landlord decides to redevelop a portion of the inline building containing the premises into condominiums and sell said condominiums to third parties. Pursuant to a provision in the lease that allows landlord to alter tenant's pro rata share from time to time, landlord notifies tenant that tenant's pro rata share is now 33%. Tenant is justifiably aggrieved, because – although a portion of the inline center is now condominium units – neither shopping center common area, nor CAM costs, have been materially reduced. Tenant now pays a larger share of those costs.

Tenants can negotiate to mitigate this concern by requesting that landlords include the concept of a "minimum GFA" within their leases. Here is a sample provision:

*"**Tenant's Share**" shall mean the ratio of the Gross Floor Area of the Premises to the total Gross Floor Area (but not less than the Minimum GFA[3]) of all Improvements within the Shopping Center.*

As with the other concepts involving CAM, the goal here is to manage and set expectations for both parties. Tenants understand that landlords need the ability to change the course of the shopping center and, if required to rehabilitate or improve the shopping center, make significant changes thereto. On the other hand, tenants do not sign leases with the expectation to have their share of CAM costs increase dramatically over time. The "minimum GFA" concept permits both parties to have clear lines within which to conduct its business.

III. Capping CAM

As discussed in Section I, CAM is typically estimated by the landlord for each lease year, the tenant pays estimated amounts throughout the lease year, and then the parties reconcile after the year is completed. Tenants with high credit can negotiate a variety of manner to cap how much CAM the tenant is required to pay on a year in, year out basis.

The first line of approach for tenants looking to limit CAM costs through a cap is to focus on permitting landlords to request capped reimbursement of "controllable" CAM costs, and uncapped reimbursement of any "uncontrollable" or "non-controllable" CAM costs. The rationale for both parties is clear: if the CAM costs are "controllable", Landlord can choose when, how, and how much of such costs to incur, and a cap operates to encourage landlords to reduce their expenses where they can; if the CAM costs are uncontrollable, then landlords should not be penalized for incurring them, because (in theory) landlords have no choice but to incur them.

Most leases tend to define uncontrollable CAM costs as a list of various expenses, and controllable CAM costs as any CAM costs other than uncontrollable CAM costs. The dynamic in the negotiation here is similar to the dynamic when negotiating CAM exclusions: landlords and tenants are both looking for market and fair provisions. A typical list of excluded CAM expenses is as follows: snow and ice removal, utility costs, security, costs incurred as a result of changes in applicable governmental laws, and – for landlords with significant leverage – "any costs that are by definition "uncontrollable".[4] Tenants should attempt to make such list as short as possible, while landlords should seek to list as many "uncontrollable" costs and expenses as landlord can reasonably include.

The second line of approach for tenants looking to limit CAM costs through a cap is the cap itself. Caps, phrased in terms of percentage increase year over year (e.g., CAM is limited to a three percent (3%) increase each year), come in many shapes and sizes. Landlords prefer caps that are both "cumulative" and "compounding". This is to say, if a cap is 3% on a year-over-year basis, then, as each year goes by, the cap increases by 3% (or, if the cap is compounding in addition to being cumulative, then the cap increases by the multiple of 1.03 each year). irrespective of how much CAM costs were incurred the prior year. Assuming a 3% cumulative and compounding cap, if in Year 1, CAM costs were $5/sf, in Year 2, CAM costs were $5/sf, and in Year 3, CAM costs were $5.25/sf, then the landlord may pass through the entire amount of CAM costs in Year 3.[5]

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[3] An example of the "minimum GFA" applied would be in a shopping center that is 100,000 feet of GFA, the minimum GFA would be 75,000.

[4] Tenants should resist this final conclusion, as "the exception that swallows the rule". A common negotiating position here is to limit landlords to requesting reimbursement of any such "uncontrollable costs" to the extent that landlord can prove that other landlords in the applicable submarket containing the shopping center are considering such costs to be "uncontrollable".

[5] Applying the 3% cumulative and compounding cap, the cap in Year 2 would have been $5.15, and the cap in Year 3 would have been $5.304.

With the inverse (a non-cumulative cap), CAM costs increase only by the applicable percentage of the prior year's CAM Costs. Using the prior example, in Year 3, Landlord would only be able to pass through $5.15/sf of the CAM costs (losing the ability to be reimbursed for the incremental $0.15).[6]

Tenants clearly prefer noncumulative caps if they can get them. The applicable cap percentage is also usually hotly negotiated, with the lower the percentage, the better circumstances being for the tenant.

IV. Auditing CAM and Implementing Fixed CAM

As demonstrated in the foregoing materials, determining the amount of CAM to be paid by tenants in any given year is a matter of significant weight. Tenants and landlords spend time and money negotiating CAM provisions with the intent of meeting each party's expectations when it comes to paying the cost of shopping center upkeep. What happens when these expectations are not met on the tenant's side?

Retail tenants should, if at all possible, request an express audit right provision in their leases. Such provisions usually (1) require landlords to maintain complete and accurate records of prior years' CAM expenses; (2) permit Tenant or its auditors[7] to inspect, review and audit such records; (3) reconcile any overpayments made by tenants that are found by such tenants or its auditors; and (4) if the overstatement of CAM is high enough (expressed as a percentage over the amount originally charged), requires landlords to pay for the costs of tenant's audit.

Landlords often agree to providing tenants (especially large or credit-worthy tenants) with audit rights, the primary reason being that most tenants will not exercise them during the course of their term. That said, landlords should be alert to limiting landlord's liability with respect to such audits, and – if possible – (I) negotiate for the tenant to pay for the cost of the landlord's audit unless an overstatement is found, (II) increase the percentage of overstatement that would cause landlord to reimburse the cost of tenant's audit, and limit the costs required to be reimbursed by landlord to a fixed amount, and (III) require that landlords must agree with the results of tenants audit.

With large shopping center owners and tenants with many stores, it is in both parties' interest to look for scenarios to limit the number of audits undertaken over the course of a lease term. If a tenant has significant concern around payment of CAM costs and is intending on auditing landlord's CAM costs every year, then the landlord and the tenant should consider implementing what is referred to as a "Fixed CAM" arrangement in the lease. "Fixed CAM" is what it sounds like: rather than tenant paying an estimate of CAM costs each year, and then the parties reconciling (subject to future audit), landlords and tenants agree up front to a fixed dollar per square foot of CAM costs, and then fixed increases in such amount, which is usually tied to expected CPI increases. As an example, landlords and tenants may agree to a $4/sf fixed CAM amount, with 3% increases year over year. If landlords and tenants agree to a Fixed CAM arrangement, then provisions around CAM inclusions/exclusions, CAM caps and audit rights are no longer necessary. This arrangement, while fair to both parties, also contains risks for both parties: if the CAM costs end up being much higher (or lower) than expected, then one party is likely pay too much or too little, as the case may be.

[6] Applying the 3% non-cumulative cap, the cap in Year 2 would have been $5.15, and the Cap in Year 3 also would have been $5.15. The cap in Year 4 will be $5.304.

[7] Landlords and tenants will often argue over the extent to which tenants may use auditors that are paid on contingency fee. Landlords insist that such auditors are likely to be biased in favor of finding an outcome for tenants; tenants argue that excluding contingency fee-based auditors significantly reduces the market for auditors who are willing to provide a fair and comprehensive audit.