COMMERCIAL TENANT'S LEASE INSIDER®

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The leading newsletter devoted to helping retail and office tenants negotiate, draft, and manage their leases.

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FEATURE

How to Control Office, Retail Costs at Mixed-Use Developments

Mixed-use developments are continuing to sprout up all over the nation. You, as an office or retail tenant, may be considering leasing space in one. While it can be exciting to lease space in an environment where multiple uses operate under one roof or location, there are financial risks to watch out for. Chances are high that you will end up being overcharged CAM costs and operating expenses. Left unchecked, these overcharges could hit your wallet hard.

Rick Burke, the president of Lease Administration Solutions, LLC, a company specializing in lease auditing, lease abstracting, and lease administration, regularly speaks about CAM cost/operating expense overcharges at the National Retail Tenants Association's annual conferences. Burke says that it is not unusual for office and retail tenants at mixed-use developments to get double-charged for certain costs and to be charged for services that they never benefit from. Burke has encountered a double-billing problem in his current audit of a

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FROM OUR READERS

Limit Your Liability for New-Phase CAM Costs

In a shopping center or development being built in phases, prospective tenants of an early or existing phase often start lease negotiations with a demand that they not be forced to pay CAM costs attributable to new phases, notes Charlotte, N.C., attorney Alan G. Dexter. Early-phase tenants may benefit only slightly, if at all, from the new phases' common areas. However, owners are reluctant to give in to this early-phase tenant demand, because common area maintenance is not typically performed separately for each phase.

Dexter contacted us after reading a February 2007 article titled "Attract Strong Tenants to Phased Development Without Caving In to Demands," in our owner-oriented publication *Commercial Lease Law Insider* (CLLI). The article, also available in the real estate section of our Web site, *www.vendomegrp.com*, discussed passing through new-phase CAM costs to early-phase tenants. He wanted to offer two CAM cost protections for early-phase tenants to which he has persuaded owners to agree.

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big mixed-use development owner in Boston on behalf of one of his tenant-clients.

With Burke's help, we will tell you about seven cost areas where office and retail tenants at mixed-use developments are often subject to overcharges. And we will give you tips to help you prevent those overcharges, whether you are an office or a retail tenant.

Be aware that a mixed-use development may include other types of uses, such as residential, hotel, and public facility, that will not be addressed in this article.

Differences Between Office and Retail Tenants

Many of the overcharges at mixed-use developments result from the differences between office and retail tenants, and their spaces and leases, says Burke. He explains the differences in this way: Office tenants typically lease space that is vertical, and not coterminous or contiguous—that is, not enclosed within the same boundary or adjoining. Their space is based on rentable square footage, and it includes lobbies and common areas.

However, retail tenants typically lease space that is horizontal, coterminous, and contiguous; is based on leasable square footage; and does not include lobbies or common areas. Office tenants rely on building owners to provide utilities, cleaning, and HVAC maintenance services. However, retail tenants typically hire and pay for their own utility, cleaning, and HVAC maintenance services.

Office and retail tenants also use different types of leases. Office tenants often use a base-year lease, in which the tenant pays a share of operating expenses and taxes above a base amount in the years after the base year, says Burke. The base year amount is determined from operating expenses and real estate taxes during the first year of the lease. However, many retail tenants use "triple net" leases, in which they pay insurance, real estate taxes, and utilities separately from minimum rent, Burke notes.

Understanding the differences between office and retail tenants is key to knowing how to review costs at a mixed-use development to determine whether there have been overcharges, adds Burke.

SEVEN COST AREAS FOR OVERCHARGES

Whenever a mixed-use development has office and retail tenants, Burke has routinely noticed overcharges in these cost areas:

❑ Utility Costs

Problems: Many owners allocate their utility costs 50 percent to their office tenants and 50 percent to their retail tenants. That is unfair to office tenants, who typically do not use as much electricity, HVAC, and chilled water as retail tenants use, says Burke. Many office tenants work fewer hours and days than retail tenants, he notes. As a result, retail tenants consume more utilities than office tenants.

Burke has seen retail tenants get burned, too. They are often charged for office-related services that they never benefit from, he warns. For example, a retail tenant might get charged for elevators, escalators, and HVAC systems that serve only the office tenants.

Sometimes, overcharges result from an owner's forgetting to make key deductions before allocating the cost of utility costs between the office and retail tenants. For example, the owner may not deduct the utility costs and charges that a tenant pays directly to a utility vendor, fees the owner collects from a tenant for after-hours use of a utility, or fees the owner gets for allowing telecommunications service providers to lease space at the building, warns Burke. If these deductions are not made, office and retail tenants will pay higher utility bills, he says.

Helpful tips: There are ways to stay on top of your utility charges so you can head off overcharges. Burke suggests that whether you are an office or retail tenant, you should do the following:

- Confirm your utility meter number and utility use;
- Make sure that your submeters are calibrated properly;
- If a utility is not metered, install a meter to more accurately monitor your usage;
- Check whether the method the owner is using to allocate utility costs is fair;
- Check the electricity and overtime HVAC billings log to see whether any tenants paid after-hours fees and whether the owner deducted them from CAM costs/operating expenses; and
- Make sure the owner has also made deductions for elevators, escalators, parking lot utilities, and telecom fees.

❑ Insurance Costs

Problems: Burke notes that office tenants could pay a much higher insurance bill at a mixed-use development than at a typical office building. The culprits are the retail tenants. The development's owner will have to spend more to get insurance to cover retail establishments, such as bars and restaurants, that stay open late and attract many people, says Burke.

Thus, the risk of injury is higher at retail establishments than in an office space. However, the owner may still split the insurance cost evenly between the office and retail tenants, he warns.

Retail tenants also may pay too much for insurance. Some owners pass through to retail tenants the costs for insuring common areas that serve only the office tenants, notes Burke.

Both office and retail tenants may pay more than they should in insurance costs in another way: If the owner has a blanket insurance policy that covers many buildings and centers, the owner may unfairly allocate more of the insurance costs to the mixed-use development than to its other properties, Burke warns.

Helpful tips:. Burke suggests that, whether you are an office tenant or a retail tenant, ask for, and then thoroughly review, these key insurance-related financial documents so you can determine the owner's actual insurance costs and whether you are being overcharged:

- A declaration sheet that shows what types of insurance policies the owner has on your building and what coverage they provide;
- A schedule of premiums for your building at the development that shows the premium amounts the owner's insurer has designated to your building;
- The method the owner is using to allocate insurance costs to the various developments, centers, and other properties in its portfolio;
- The method the owner is using to allocate insurance costs within your building;
- Proof of claim reimbursements and deductibles; and
- Any other relevant source documentation.

Don't simply rely on the owner's spreadsheet to determine any insurance information, advises Burke. Only by reviewing the documents mentioned above will you be able to get a good grip on the owner's insurance costs.

❑ Parking Lot Costs

Problems: Office tenants are charged for parking on a per-space basis. That charge is meant to cover all of the parking lot's or garage's costs, including insurance, repairs, maintenance, security labor, utilities, cleaning, and real estate taxes. However, owners often charge office tenants separately for each of those costs, in addition to the per-space charge, thus making office tenants pay twice for the same thing.

Retail tenants can get overcharged, too. Burke has noticed that many owners allocate the full parking lot expense to their retail tenants, without any deduction or allocation for office tenant parking payments. As a result, retail tenants end up paying some costs that were already paid by office tenants, he warns.

Helpful tips: If you are an office tenant, Burke says you can protect your wallet from double-paying parking lot costs by doing the following:

- Request the owner's general ledger for office tenants and parking

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Mixed-Use Developments

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lot invoices to verify the costs of the parking lot; and

■ Check whether the owner separately passed through to you the parking lot's insurance, repairs, maintenance, security labor, utilities, cleaning costs, or real estate taxes costs.

If you are a retail tenant, Burke suggests that you do the following to prevent parking lot cost overcharges:

■ Request a list of the tenants that pay for parking on a per-space basis;

■ Verify how much of the office tenants' payments are applied to certain parking lot costs—for example, if the owner is applying the office tenants' payments to repair and maintenance costs, you should not receive a bill for 100 percent of those costs; and

■ Check that the owner has made the required deductions for the office tenants' parking payments from total parking lot costs.

❑ Administrative and Management Fees

Problems: For office tenants, management fees are calculated based on a percentage of gross revenue. However, owners can make office tenants overpay. By adding costs from nonbuilding sources—such as interest from investments—the gross revenue figure will inflate, thus increasing the management fee, notes Burke.

With retail tenants, an owner might try to charge both an administrative and a management fee that cover the same services, warns Burke. Thus, retail tenants pay twice for the same thing.

Be aware that an owner may also pass through administrative and management fees to office and retail tenants, even if their leases don't authorize the owner to do so. And an owner may hire a relative as the administrator or manager, and inflate the cost of his or her services.

Helpful tips: If you are an office tenant, check your lease to see whether you must pay a management fee, advises Burke. If you must, make sure that gross revenue does not include costs from nonbuilding sources, he says. Also, find out whether the manager is related to the owner and whether his or her fee is inflated.

If you are a retail tenant, check your lease to see whether you must pay an administrative fee. Make sure that your CAM cost reconciliation statement does not include a management fee in addition to an administrative fee, says Burke. Also, find out whether the administrator is related to the owner and whether his or her fee is inflated.

❑ Cleaning, Janitorial Service Costs

Problems: An owner often pays a set amount to a cleaning service to clean all of the office spaces in the building. If there are vacancies in the building, the cleaning service will typically credit the owner for empty office spaces. However, owners in mixed-use developments don't often deduct those credits from the cleaning cost that it passes through to its office tenants, says Burke.

As a result, office tenants pay cleaning costs for empty spaces that don't require cleaning and for which the owner was not charged. Plus, the owner may allocate to office tenants the cost of cleaning supplies that are not for the office tenants' common areas, but for common areas serving other uses.

Unlike office tenants, retail tenants typically supply their own cleaning services. Despite that, an owner may try to make retail tenants pay the cost of cleaning interior offices and common areas not used by retail tenants or their customers.

Helpful tips: If you are an office tenant, do the following, says Burke:

■ Verify costs for cleaning supplies, cleaning labor, and service contracts by reviewing the owner's cleaning invoices and general ledger for office tenants;

■ Make sure you are paying only for cleaning supplies for common areas that serve you, and not for any other tenants' spaces or common areas not serving office tenants; and

■ Inquire about vacancy credit from vendors, and make sure the owner deducted those credits from the cleaning cost.

If you are a retail tenant, do the following, says Burke:

■ Verify costs for cleaning supplies, cleaning labor, and service contracts by reviewing the owner's cleaning invoices and general ledger for retail tenants; and

■ Confirm that office interior and common area cleaning is not included in your CAM cost reconciliation statement.

❑ Security Costs

Problems: Office tenants might be billed for security intended solely for retail tenants and retail customers. For instance, office tenants could be charged for the extra security services needed to keep shoplifters out of retail tenants' spaces.

Likewise, retail tenants might be billed for security intended for the development's common areas that serve only the office tenants.

And the owner might use its own labor force for security and greatly inflate the cost of the security force, and then pass along that inflated cost to office and retail tenants.

Helpful tips: Whether you are an office or a retail tenant, verify the development's security costs to make sure you are not being overcharged, says Burke. To do that, request from the owner the appropriate general ledger as well as details about the following:

- Security labor and equipment costs;
- Security contracts; and
- Security workers' names, time sheets, and sample pay stubs if the development uses an internal labor force.

❑ Real Estate Taxes

Problem: Office tenants can get burned by real estate taxes at a mixed-use development, warns Burke. A tax department may assess the value of the development based on an income method, instead of a replacement method, factoring in retail tenants' sales. The result is that the development is assessed at a higher rate than typical office buildings, and the office tenants receive higher tax bills.

Helpful tips: If you are an office tenant, protect your wallet from an unfairly high tax bill by doing the following, says Burke:

- Get a tax map and property record card from the tax assessor's office. Those documents will help you determine whether you are paying tax on the right property. Burke has seen owners send tax bills to tenants for properties that the tenants did not occupy;
- If the tax department is using the income method to assess the development's value, ask an attorney to determine whether your building in the development has been evaluated correctly;
- Make sure that the base year tax amount in your lease is not understated, or else you will end up paying too much of the tax bill in the years after the base year; and
- Verify allocations of real estate taxes between the development's office and retail tenants to determine whether you are paying a share of the tax bill that should be allocated to the retail tenants.

Practical Pointer: Keep in mind that a mixed-use development is not a typical office building and shopping center. Within the uses in a mixed-use development are different-size tenants with different leases. As such, there are no clear-cut standards in the real estate industry on how best to allocate the costs of maintaining the development's common areas among the various uses.

However, as a tenant, your goal is to make sure you are paying a fair and reasonable share of CAM costs or operating expenses, says Burke. And the owner should be able to justify that its cost allocation method is fair and reasonable.

Insider Source

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New-Phase CAM Costs

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Two Protections for Early-Phase Tenants

If you are considering leasing space in a phased development and will occupy space in an early phase, try to get the following two protections regarding new-phase CAM costs:

Adjust CAM cost formula. Your proportionate share of CAM costs is calculated by a formula, which is typically presented as a fraction. The fraction's numerator equals annual CAM costs multiplied by the actual number of square feet of your space. The denominator is the actual number of square feet of all leasable spaces at the development served by the common areas, says Dexter.

If the numerator gets larger—because CAM costs or the size of your space increases—while the fraction's denominator stays static, decreases, or increases at a slower pace than the numerator, your proportionate share of CAM costs will go up.

However, here are two ways to tinker with the fraction so you don't get burned by new-phase CAM costs, says Dexter:

➤ *Add new-phase leasable space to fraction's denominator.* If you must

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New-Phase CAM Costs

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agree to include CAM costs for a new phase in the fraction's numerator, require the owner to include in the denominator all leasable space to be constructed for the new phase, says Dexter. This way, you are increasing both the numerator and the denominator, thus helping you to keep your proportionate share under control. And this requirement prevents you from paying a disproportionate share of CAM costs attributable to new phases that have not finished construction, he adds.

Example: CAM costs for your phase are $10,000. Your space is 5,000 square feet. Your phase is 100,000 square feet. Your proportionate share of CAM costs is $500 ($10,000 x [5,000 ÷ 100,000]). Suppose a new phase's CAM costs would result in an additional $10,000 in CAM costs and an additional 100,000 square feet.

If, halfway through construction of the new phase, the owner added the new-phase CAM costs to the numerator while only adding 50,000 square feet to the denominator, your proportionate share of CAM costs would be $667. In other words: $20,000 in CAM costs from your phase and the new phase x 5,000 sq. ft. ÷ 150,000 (the square footage of your phase plus one-half of the new phase).

But by increasing the denominator by all of the leasable space to be constructed, your proportionate share of CAM costs would remain at $500. In other words: $20,000 in CAM costs from your phase and the new phase x 5,000 square feet ÷ 200,000 (the square footage of your phase and the new phase).

➤ *Exclude enhanced amenity maintenance costs from fraction's numerator.* If the new phase will include enhanced amenities—such as water features, enriched hardscape, or heavy landscaping—with higher maintenance costs than the amenities in your phase, don't allow the owner to add those enhanced amenity maintenance costs to the CAM cost amount in the numerator of your CAM cost formula, says Dexter. After all, you should not have to subsidize upgraded amenities that will primarily benefit tenants in new phases, he explains.

Require completion/occupancy requirements for new phases. New-phase CAM costs (in the fraction's numerator) and new-phase leasable space (in the fraction's denominator) should not even enter into the proportionate share calculation until, at a minimum, all new-phase construction is complete and the new space is at least 70 percent occupied, says Dexter. This will significantly protect you from the higher CAM costs that inevitably result from major construction activities, he adds.

If the owner does not agree to those minimum requirements, consider asking the owner to exclude from CAM costs any expenses arising from construction of the new phase—such as mud removal, debris cleanup, and pavement repair, says Dexter. But owners may be reluctant to segregate normal and construction-related maintenance costs, he warns.

Add Lease Language

To get those protections, Dexter suggests that you add the following language to your phased development lease, where it discusses CAM costs:

Model Lease Language

a. The Premises will be located in Phase 1 of the Shopping Center. Landlord may not charge Tenant for any share of CAM Costs attributable to any new phase of the Shopping Center unless:

(i) All buildings planned for that new phase have been constructed;

(ii) The leasable space in those buildings has been added to the denominator of the formula used to calculate Tenant's proportionate share of CAM Costs, and

(iii) [*Pick one*:] [*at least 70 percent of the leasable space in those buildings is occupied by retail tenants*] or [*Landlord excludes any expenses arising from construction of the new phase, e.g., mud removal, debris cleanup, and pavement repair*].

b. If the new phase includes enhanced common area amenities (such as fountains, brick pavers, or landscaped courtyards) not present in Phase 1, then Landlord shall exclude the maintenance costs for those enhanced amenities from the numerator of the formula used to calculate Tenant's proportionate share of CAM Costs.

Show our Model Language to an attorney in your area before using it in your leases. ■

Insider Source

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RECENT COURT RULINGS

➤ Tenant Entitled to Fees, Defense Costs from Owner

A pedestrian slipped and fell on a sidewalk outside of the tenant's store, which was located in a mall. The pedestrian sued the tenant and the mall owner for damages. The tenant, in turn, demanded that the owner indemnify the tenant for fees and other expenses relating to the tenant's defense in the injured pedestrian's lawsuit. A lower court refused to set the amount of the fees and defense costs that the owner owed the tenant.

An Ohio appeals court ordered a hearing to set the amount of fees and defense costs the owner owed the tenant. Under the lease, the owner had the duty to maintain the common areas, including the sidewalk, and to indemnify the tenant for claims arising from the common areas.

There was no evidence that the tenant or any of its employees contributed to the defective state of the sidewalk, noted the court. Rather, the injured pedestrian's claims related to the owner's negligence in maintaining the sidewalk. Therefore, the lease clearly covered the pedestrian's lawsuit, said the court. Thus, the tenant was entitled to reimbursement of its legal fees and defense costs.

- Chapman v. Tri-County Mall: Appeal No. C-060271, 2007 Ohio App. LEXIS 928 (Ohio Ct. App. 3/9/07).

➤ Owner Violated Implied Duty of Cooperation

A shopping center lease gave a tenant a renewal option for five years at a specified base rent, plus unspecified common area maintenance and taxes. Months before the deadline to exercise the option, the tenant requested information from the owner about the estimated charges for maintenance and taxes. The owner declined the request, claiming that the lease didn't require the owner to supply that information.

After the deadline to exercise the renewal option had passed, the owner asked the court to determine that the option had expired and the tenant must vacate the space. The tenant exercised its option following the deadline, after the court had ordered the owner to disclose the maintenance and tax information.

A Florida appeals court dismissed the owner's lawsuit. By refusing to supply the tenant's requested information, the owner had violated an implied duty to cooperate with the tenant, said the court. The court said that if the lease had expressly stated that the owner was not responsible to furnish the requested information, the owner would have been allowed to withhold that information.

However, the lease was silent on that issue. Therefore, the owner should have supplied the requested information to the tenant, which would have allowed the tenant to make an informed decision about whether to exercise the renewal option, said the court.

- PL Lake Worth Corp. v. 99Cent Stuff-Palm Springs, LLC: No. 4D06-1541 (Fla. Ct. App. 3/7/07).

Lesson Learned: Make sure your lease doesn't include language permitting the owner to withhold information from you relating to renewal terms. Without that lease language, you have a stronger case that the owner violated a duty to cooperate or act in good faith with you if the owner refuses to supply your requested information before the renewal option deadline passes.

➤ Tenant's Refusal to Pay Additional Rent Violated Stipulation of Settlement

An owner sued a tenant for nonpayment of base rent and additional rent. The parties signed a "stipulation of settlement" in which the tenant agreed that if the tenant didn't pay its overdue rent in six installments, from January 2007 to June 2007, the owner could evict the tenant. The stipulation also required the owner or its attorney to notify the tenant's attorney if the tenant defaulted in the payments.

The stipulation mentioned that "time was of the essence" as to the tenant's obligations under the stipulation. The tenant paid base rent for January 2007 and February 2007, but the payment didn't include additional rent. The owner sent default notices to the tenant's attorney. Then, the owner tried to evict the tenant. The tenant asked the court to stop the eviction.

A New York court refused to stop the eviction. The court noted that stipulations of settlement are strictly enforced because the parties are free to "chart their own litigation course." The tenant didn't dispute that the owner was entitled to both base rent and additional rent under the stipulation. And the tenant could not prove that it had paid the additional rent.

Because the tenant had no excuse for not complying with the stipulation's "time is of the essence" payment provision, the tenant was not entitled to terminate the eviction, said the court.

- Madison/64th Properties, LLC v. SKV, Inc.: L&T Index No. 092708/06 (N.Y. Civ. Ct. 3/2/07).

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Recent Court Rulings (continued from p. 7)

➤ Fitness Center Didn't Comply with Rent Clause

A lease required a tenant to use a space as an athletic club. The rent clause required the tenant to provide the owner monetary rent and "four full memberships to the athletic club to be operated by Tenant within the Premises." The term "athletic club" referred to a full-service facility open to both sexes.

The tenant closed the facility for a month, auctioned off its equipment, and reopened as a greatly reduced capacity "women's facility." The tenant stopped providing the four full memberships to the owner. The owner then tried to evict the tenant for violating the lease. The tenant argued that the membership requirement didn't apply, because the tenant was no longer a full-service facility.

A Wisconsin appeals court ruled that the owner could evict the tenant. The court noted that the parties were not dealing with a mere use clause situation but with a rent clause that expressly required the tenant to provide the owner with four full memberships to an athletic club in the space. Thus, compliance with the rent clause required an ongoing athletic club, said the court.

However, the tenant didn't provide a full-service facility open to both sexes. Instead, the tenant supplied a greatly reduced capacity facility open only to women. And giving memberships to a female-only facility at the space would not satisfy the lease's rent clause, noted the court. ■

- 44 Associates L.P. v. Capital Fitness, L.L.C.: No. 2005AP3091, 2007 Wis.. App. LEXIS 214 (Wis. Ct. App. 3/8/07).

ASK THE *INSIDER*

Ordered to Get Terrorism Coverage When Lease Is Silent

Q My lease requires me to get insurance policies covering my space and personal property, but it does not specifically mention terrorism coverage. However, the building's manager is demanding proof that my insurance includes terrorism coverage. Must I get the terrorism coverage?

A If your lease does not specifically require you to get that coverage, the manager—and the owner—may have no right to force you to get terrorism coverage, says litigation attorney Warren A. Estis. If the manager persists in demanding that you get terrorism coverage, tell him about a new court case from New York in which the owner was prevented from forcing its tenant to get terrorism coverage, because the lease didn't discuss that coverage, Estis says.

Specifically, in that case, Estis's tenant-client signed a lease that required the tenant to "maintain insurance on the building against loss or damage by fire and against loss or damage by other risks included under the standard Extended Coverage Endorsement... ." The tenant's original all-risk policy included terrorism coverage.

However, because the policy came up for renewal after the terrorist attacks of Sept. 11, 2001, the tenant's insurer specifically excluded terrorism coverage from the renewal policy.

The owner sent the tenant a default notice because the tenant had gotten insurance that did not include terrorism coverage. The tenant asked a court to determine whether the tenant must get terrorism coverage.

A New York appeals court ruled that the tenant was not responsible for getting terrorism coverage. The court noted that when the lease took effect in 1989, the Extended Coverage Endorsement enumerated those perils that were included and excluded from coverage—but terrorism was not among them. The court said that an insurance policy should not be extended beyond its plain meaning to include perils not specifically covered by its provisions.

Also, terrorism coverage was not mentioned anywhere in the lease. The court noted that it would be unfair to require the tenant "to assume an obligation that was not reasonably within [its] contemplation" when it signed the lease.

As a precaution, check with an attorney in your area to see whether your local laws differ on this issue, notes Estis. ■

- TAG 380, LLC v. ComMet 380, Inc.: Index No. 118730/02, 591131/02, 8937-8938, 2007 N.Y. App. Div. LEXIS 1785 (N.Y. Sup. Ct. App. Div. 2/13/07).

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