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PART II
IDENTIFICATION AND CALCULATION OF LEASE PASS THROUGH EXPENSES

Part I of this series addressed the definitional and operational aspects of various types of leases including a traditional gross lease together with the various permutations of net leases. This article will address the issue of proper and appropriate pass through expenses and how they are calculated and the use of commercial lease audits to identify proper and appropriate commercial lease pass through expenses.

The fundamental concept of a “net lease” is to identify those specific expenses which pass through to the tenant. The lease should provide the tenant with an accounting annually and an opportunity to perform a commercial lease audit to establish that the pass through expenses being charged to the tenant are in fact accurate and verifiable. This ensures the tenant is paying only those sums that have been identified in the lease as a pass through expense.

In the simple example of a stand alone building with a net lease requiring base rent and a pass through of only real property taxes, the tenant does not even need a commercial audit, but rather can easily identify the pass through amount by a search of the public records as to the actual real estate tax bill for the stand alone commercial property and then calculate its monthly contribution to pay such contribution for the tax bill. In the example of the stand alone building where the annual real estate tax bill is $2,400.00, the commercial tenant can verify that the 1/12 monthly pass through expense for the prior year would have been at $200.00 per month based upon a $2,400.00 annual tax bill which would reflect the agreed upon base rent plus the $200.00 per month pass through expense of tenant’s contribution to pay real estate taxes for the premises.

Identifiable and verifiable calculations for pass through expenses become more blurred and difficult when the pass through expenses are not verifiable from the public records and require application of percentage ownership interest of a particular commercial center with specific billings which may in fact overlap each other. By way of example, in contrast to the simple net lease on a stand along building with base rent and real estate taxes, take the example of a commercial lease of a shopping center in which the common area expenses are identified as the tenant's proportional amount for all operational expenses of the center. This may include real property taxes, insurance, maintenance, repairs, common area maintenance, security, management fees, marketing fund, commercial center premises promotional expenses, reserve fund and other identifiable pass through expenses.

This is an example of a broad brushed pass through expense in which the landlord is passing along every potential expense the landlord would incur for the operation of the center or expenses which are even related to the operation of the center. Under such circumstances, the tenant needs to be provided with accurate information. The tenant should first verify and establish the tenant's actual percentage lease space versus the entire center to obtain a base percentage to calculate the tenant's obligation. This initial calculation is further compounded by the fact that there are various definitions of percentage space which can be actual lease space, leasable space, rentable space, gross leasable space or additional common areas allocated to the tenant.

Example: A tenant in a 100,000 square foot center may have the physical use of only 10,000 square feet, but based upon the formula and format for its particular lease premises, the have attributed to the tenant a percentage of the contribution which requires it to pay more than the simple 10% that it occupies against the outstanding total sum of the pass through expenses. This is an example of a contractual obligation in which the tenant needs to be aware of since a court will not disturb an agreed upon negotiated contractual term barring fraud in the inducement or some other legal defense. (See Part IV of this series). In addition to identifying a specific contractual percentage of the pass through expenses, the tenant needs to identify those expenses with particularity to make sure that:

a. Those expenses are identified in this lease;

b. Those expenses can be attributed to the definitional aspects of a lease provisions relating to the pass through expenses and;

c. The calculations are based upon the percentage and actual costs and that the amounts are adequately calculated.

Often times the landlord and tenant dispute the common area maintenance charges that are included in the lease based upon vague and ambiguous language which has a number of interpretations. This will render the contractual language ambiguous and requires the interpretation of such language by the Court. (Again, see Part IV of this article).

It should be recognized that lease negotiations and various lease revisions, together with any amendments as well as schedules and exhibits, can create an instrument which is significant in length for the average layman, sometimes in excess of fifty (50) pages or even longer for more sophisticated commercial leases. When the first invoice appears, the tenant or the tenant's agent assigned to review the invoices (such as internal accounts payable manager, accountants, etc.) needs to be able to identify all aspects of the lease, its application and pass through expenses as against the actual bills being received.

In today's troubled real estate economy, sometimes the issues are overlooked, such as situations in which real estate taxes (for one of the few times in Florida) are actually dropping based upon the landlord's efforts to reduce such real estate taxes and the employment by the landlord of attorneys or real estate property tax advisors to reduce. Often times the cost to relieve the landlord of such real estate liability are pass through, but the actual cost savings are not passed through to the tenant. Again, this may be from oversight by the landlord or in certain cases where the landlord is looking at the common area maintenance cost as a profit center.

One other area that the tenant needs to be concerned about in paying its proportional rent is to make sure whether the proportionate share of its obligation is negotiated based upon "gross leasable space" or "gross lease space". This distinction can be significant, and is especially pronounced in today's troubled real estate times when vacancies are on the rise especially in Florida.

By way of example, using our 100,000 square foot center of which that the tenant occupies 10% and its lease is based upon proportionate pass through expenses on gross leasable space, then in such event the tenant is always going to pay pass through rent based upon the aforementioned example, 10% as the attributable common area maintenance pass through expenses.

However, if instead of the term, "gross leasable space" the term "gross leased space" (which is only slightly different in spelling but significantly different in application) was applied, then in such event, and with a 50% vacancy rate at the premises, the tenant would actually be paying two times the amount of pass through rent. In such example, the 100,000 square foot center, being only 50% leased up, the tenant's 10% leased space would be numerator and the overall gross leased space (50,000 square feet) would the denominator. The tenant would be paying 1/5 or 20% of all the common area maintenance pass through expenses under a gross leased space pass through provision even though it occupies only 10% of the entire center.

This is a trap for the unwary commercial tenant who overlooks this particular term and is beneficial to the commercial landlord since the commercial landlord will always continue to pass through 100% of the operational expenses of the center even if the center is only marginally occupied. This can have a devastating effect on the unwary commercial tenant and is even more of a trap in today's real estate economy.