NOVEMBER

2010

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COMMERCIAL LEASE NEWSLETTER

PART I

NET LEASES AND COMMON AREA MAINTENANCE CHARGES: ISSUES FOR THE COMMERCIAL LANDLORD AND TENANT

FUNDAMENTALS OF THE GROSS LEASE V. NET LEASE CONCEPTS

This newsletter will be comprised of four (4) separate installments identifying the concepts of net leases and common area maintenance charges which impact and affect the rights of commercial landlords and tenants. These issues are even more significant in today's current troubled real estate times since both the commercial landlord and commercial tenant are looking to cut costs and expenses as well as maximize their respective savings and sometimes those negate efforts run counter to each other. Further and dependent upon the structure of a lease, both the landlord and tenant need to verify the methods of calculating contributions under various net lease arrangements and leases. Common Area Maintenance charges are often times calculated utilizing concepts or formulas which are not consistent with the lease agreement itself or follow Florida law. Those issues will likewise be identified and discussed.

1. **Gross Lease v. Net Lease.** Most commercial leases are net leases with some contributions by the commercial tenant towards the operational costs of the subject lease premises. This differs from the gross lease concept which essentially indicates that the tenant pays a fixed flat fee on a monthly basis to cover an agreed upon and negotiated monthly lease payment. These gross leases are generally fixed for one (1) year and escalate on an annual basis, all of which is negotiated by the commercial landlord and tenant at the commencement of the lease.

   A net lease differs from a "gross lease" also refereed to as "full service lease". The fundamental concept of either a gross lease or a full service lease is that under either the gross lease or full service lease the lease agreement would cover all taxes, insurance, maintenance, utilities and rent. Under a "gross lease" or "full service lease" the tenant pays a predetermined lease each month without any adjustments for increases in the operational costs of the commercial property or pass throughs for any specific expenses incurred by the landlord.

2. **Various Permutations of Net Leases**. A net lease is broadly defined and differentiated from a gross lease in that under a net lease scenario, the landlord and tenant negotiate a basic fair market value rent for the property, (base rent) and then negotiate all or a percentage of the operational costs of the center, predicated on differing theories and a formula for allocating contribution. The net lease can be identified as "a single net lease", a "dual net lease" or a "triple net lease".

    a. **Net Lease**: One classic definition of a net lease is a situation in which a lease is put in place and the tenant and landlord agree on a base monthly rent for the premises. Potentially there will be annual increases based upon a fixed percentage as well as payment by the tenant of an identifiable cost expense for the subject lease premises. This net lease or single net lease may have the tenant paying for the real estate taxes for the building (assuming it is a free standing building) or alternatively, the tenant may be paying a percentage of the real estate taxes based upon the proportionate amount of the tenant space in relation to the building. The identifying sum can be passed through to the tenant. Example: Base rent $2,500.00 per month with additional past through expenses of $200.00 per month based upon taxes of $2,400.00 per year for total monthly rent for a total monthly rent of $2,700.00 plus tax.

    b. **Double Net Lease**. This, among other permutations, would indicate the same format that is a base monthly rental payment where a tenant is paying a proportion amount for the attributable real property taxes and property insurance. Again, both the real property taxes and the property insurance are identifiable fixed sums that are allocated to the property in the form of a specific building with identifiable annual property tax bill in and annual insurance cost billable monthly. Alternatively, a tenant may pay a proportion amount of the annual tax bill and property insurance based upon 15% of the occupancy.

    c. **Triple Net Lease**. This is a common format a commercial lease. Both the net lease and permutations of the double net lease are in the market place for smaller buildings and are subject to negotiations between the commercial landlord and commercial tenant. In comparison and in contrast to the full service lease and distinguishable from the net lease or double net lease, a triple net lease requires a tenant to carry base rent while also incurring the cost for the apparitional maintenance of the property.

        Sometimes the triple net leases are referred to as a "NNN" (Net/Net/Net) which represents the fact that the triple net lease provides that the tenant actually pays all costs and maintenance associated with the building. This enables the landlord to recover from the tenant, in the form of triple net rent, all costs associated with the operational aspects of the premises and also an agreed upon base rent for return on its investment. The triple net lease generally is represented by net cost as to property taxes, insurance and maintenance as indicated.

With the triple net lease, the landlord also will pass along additional expenses such as utilities, property management fees, and other fees that can be negotiated and may be attributable through the ownership, management, maintenance or promotion of the specific property. One example of a pass through shopping center lease would be a contribution to a marketing fund where fees are not directly attributable to the actual costs of operation of the premises, but contribute to the overall goal of the tenant, to wit: generation of additional retail customer traffic which arguably benefits all tenants at the center.

In each lease negotiation between the commercial landlord and commercial tenant, the components of triple net leases need to be fully negotiated and calculated so that the commercial tenant can identify the true cost of leasing commercial premises. Arguably, the commercial landlord (if in fact calculations are identified specifically) will recapture from that tenant all of its operational cost of the particular lease premises or 100% of its operational costs for the proportion amount of the lease premises, together with an agreed upon base rent rate which is consistent with the current lease market as well as the landlord's projected return on investments. The commercial tenant however needs to be more particular in regard to identifying specific lease payments. These lease payments need to be identified so that the tenant can know what its total overhead expenses are for the lease premises which are far greater than base rent. Many tenants fail to take this into consideration and simply accept an estimated budget for the pass through without identifying specific caps or the basis for evaluating the pass through expenses.

3. **Negotiated Caps on Pass Through Expenses**. Some tenants with negotiating leverage are able to negotiate with the landlord a specific cap for annual pass through expenses so that the commercial tenant can identify and estimate the total "all in" expenses for both base rent and pass through expenses so that the tenant would absorb or be charged for the commercial lease premises. This allows a commercial landlord and tenant to negotiate a specific fixed fee ("cap") which gives a commercial tenant specificity and a maximum annual sum so that in the event of substantial increase and operational expenses, utilities or management fees, the tenant is now powerless and does not have to absorb all such increases.

   Several examples of this would be a situation in which the commercial landlord decides to pay a premium management fee for the premises or fails to negotiate the best rates for insurance policies, maintenance expenses and the like. The fact that the commercial landlord does not operate their commercial property in the most efficient manner should not be passed onto the tenant. The commercial landlord, without any caps on expenses, does not have the pure economic incentive to reduce operational expenses since all of those operational expenses are ultimately passed along through the tenant. The only true economic factor is that the landlord ultimately would not be providing the best lease to the tenant in relation to other comparable property, and might lose the tenant in the future to another commercial property. This is small solace to the commercial tenant who has to suffer through years of inefficient management by a commercial landlord only to vacate the subject premises to find a better commercial lease deal.

4. **"Management Fees" Pass Throughs**. Another area for concern for commercial tenants is the "management fee" pass through language contained in the standard commercial landlord's lease. If in fact the commercial landlord can pass through whatever management fee it decides to incur at the premises, then in such event the commercial tenant may be subject to paying proportionally a higher commercial property management fee then would normally be chargeable. In many instances, commercial landlords themselves utilize this fee to tack on a property management fee for themselves or an affiliated entity which may not be truly reflective of property management, but in fact acts as a profit center for the commercial property owner.

   By way of example, a typical commercial property manager working independent of a commercial property owner may charge $0.75 cents per square foot for an annual property management fee for a 100,000 square foot center. The annual cost for the property management would be $75,000.00. The property manager in such scenario would be responsible for overseeing the entire operational aspects of the center which might also include a marketing budget, maintenance, expenses, repairs, utilities as well as tenant issues inclusive of assisting with tenant communications and negotiations. Often times with a "captured" management company or a management fee that the commercial landlord sets up for itself or some unrelated entity, management fees begin to balloon which allows the commercial property owner to utilize the commercial property management fee pass through aspect as a "profit center" to supplement the lease payments.

   An example of a property manager passing through a "commercial property management fee" could be a situation whereby the fee is higher than the $0.75 cents per square foot as a result of separately charging for the salary of its commercial property manager and then including affiliated charges. These charges are redundant in nature and balloon the overall pass through common area maintenance expenses and increase the overhead cost for the commercial tenant. This is an immediate economic pitfall for the tenant but also exposes the commercial landlord to potential claims from the tenant based upon a number of theories such as unconscionability, violation of Florida Unfair and Deceptive Trade Practice Act (FUDTPA) and other theories which may be established by an aggrieved tenant.

(See Part III and IV of this series regarding commercial landlord and tenant legal rights remedies and issues).

Next Month, Commercial Lease Audits.