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Commercial Leasing

LEASING TRENDS

Streamlining the Negotiating Process By Using Either Flat CAM or Gross Leases

By Jay A. Gitles

In today's economic environment, it is essential for businesses to find more efficient methods for accomplishing their objectives and streamline the process by which transactions are documented. One of the more discernible trends in the commercial real estate industry is the move away from the traditional net lease in favor of a prenegotiated, fixed fee—specifically, the flat CAM and, to a lesser extent, the gross lease. The appeal of the flat CAM to both landlords and tenants is primarily due to the fact that it removes (or at least reduces) one of the more contentious business items from the negotiation process. The industry shift toward the flat CAM and gross lease continues to be fueled by the need to simplify lease negotiations, reduce disputes over who pays for certain operating expense, and, ultimately, build mutually beneficial landlord-tenant relationships.

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Why Choose a Flat CAM or Gross Lease?

Considering the financial and business efficiencies that can result from expedited lease negotiations, it is hardly surprising that the flat CAM and gross lease are becoming alternatives to lengthy negotiations over specific expense issues and exclusions. But to appreciate fully the motivation behind choosing a flat CAM or gross lease, it is helpful to consider first the nature of traditional net lease negotiations, as well as some of the issues that commonly arise during the process.

When negotiating a conventional net lease, landlords and tenants are commonly at odds as to how broadly or narrowly the term "operating expenses" should be defined. Typically, landlords want to pass along most, if not all, operational and maintenance costs to tenants, while tenants want to exclude many such costs. Accordingly, the lease negotiation process often gets bogged down by the sheer number of operating expense issues that are put "in play."

Some of the more contentious "operating expense" related issues center on the cost of compliance with existing and new laws, capital expenditures, hazardous substance removal/compliance, management fees, garage expenses, real estate tax increases triggered by the sale of a property, uninsured portions of casualty damage, detention ponds and off-site improvements, and business interruption and rent loss insurance. In addition, several issues related to operating expenses, such as audit rights, caps on CAM, "gross-up" provisions, and "cost pooling," are sources of heavy negotiation. Disagreement on these issues can significantly lengthen negotiations, which can cost both parties financially and undermine the basis for a successful and trustworthy landlord-tenant relationship.

Consider, for example, the issue of compliance with a new law. If, somehow, a change in local zoning law dictated that certain types of properties must increase the number of parking spaces within some period of time, who should bear the cost of complying with the new law—the landlord or the tenant? What if the zoning law was already in effect at the time the lease was signed, but the property was not yet compliant? If the costs are to be

passed through to the tenant, over what duration would they be amortized? At what interest rate? These are but a few of the questions that a traditional net lease should answer. Obviously, there are no "right" answers for all situations. However, in the example presented above, a flat CAM lease would probably eliminate the time, effort and money spent negotiating the issue. Accordingly, the popularity of the flat CAM and gross lease becomes more obvious under these circumstances.

Benefits and Advantages

At the very least, the flat CAM or gross lease can diminish the effects of lengthy battles over expense issues, saving both parties legal fees and frustration from the negotiation and, perhaps, preserving mutual trust. However, in many circumstances, a fixed expense, such as a flat CAM, can offer certain business advantages to both landlords and tenants.

From the landlord's perspective, a flat CAM can provide a competitive advantage over other properties for several reasons. As tenants become dissatisfied over what they perceive as a landlord's attempt to "shake them down" for every expense item, tenants will become increasingly open to a "no hassle" arrangement that covers unexpected expenses. Also, audits by tenants should diminish, thereby creating landlord staffing savings. Further, while there will be some years in which landlords come out behind on expenses (and some years where they come out ahead), in the long term, a flat CAM provision may assure more timely receipts of payment from tenants, thereby promoting efficiency in accounting, as well as contributing to a stronger bottom line.

Tenants also receive benefits from a flat expense fee beyond the alleviation of the various headaches associated with lease negotiations. From a financial standpoint, a flat CAM allows a tenant to calculate expenses accurately because it removes all uncertainty from the fiscal equation with regard to property expenses. Under traditional net leases, tenants can experience substantial increases (15 percent or more) above a previous year's expenses, which can result in a tremor effect to the bottom line. Not coincidentally, such increases can often give rise to landlord audits.

In addition, tenants often perceive that under a traditional net lease, landlords lack sufficient incentive to control expenses because they ultimately pass them through to the tenant. A flat CAM lease can provide landlords with even greater motivation to provide services more efficiently and effectively. As a result, tenants may increasingly view landlords as their partners, rather than adversaries, which should make for successful, long-term relationships.

The Cure for Contentious Lease Negotiations?

Unfortunately, a flat CAM or gross lease cannot solve or eliminate all problems associated with contentious lease negotiations, nor are they the best course of action for every landlord or tenant in the commercial real estate arena. While these types of lease structures can offer meaningful advantages to both parties, one should evaluate the number and type of expense provisions that are most likely to be at issue in the negotiations to determine if a flat CAM or gross lease might be worth pursuing.

Neither the flat CAM nor gross lease eliminates entirely the need for negotiation over operating expense provisions. In all likelihood, a landlord will seek to pass through "uncontrollable" CAM expenses and carve them out of the flat CAM calculus. "Uncontrollable" CAM expenses customarily include utility charges, insurance costs and real estate taxes. However, in comparison to the contentiousness common to the operating expense issues in a traditional net lease, this type of negotiation is usually less demanding for both parties.

A Continuing Trend

Though it has yet to be fully embraced by either landlords or tenants, the trend toward a flat CAM and/or a gross lease has been well documented in recent years, especially in the retail sector. Perhaps the trend has been more prominent in retail because there is greater pressure to get stores open quickly before certain seasons pass, the players (i.e., large landlords and national retail chains) intersect with more regularity than other categories, and the problem with protracted negotiations is most profound in this industry segment.

Considering that the operating expense provision is often the most contentious and time-consuming portion of lease negotiations, the trend toward simplifying negotiations through a flat CAM or gross lease is likely to increasingly penetrate the commercial real estate market. In fact, developers and tenants on the retail side are progressively becoming more comfortable with the flat CAM, with industry insiders citing such positive effects as stability, increased efficiencies and savings in time and effort, as well as improvements in landlord-tenant relationships. And given the value that businesses place on "speed" in terms of closing the deal, as well as the benefits to both landlords and tenants that flow from greater efficiency, this trend will most likely expand beyond the retail property sector and become a fixture of commercial property lease negotiations.