Hot Topics in Office and Industrial Leasing

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A Brief History of CAM and Pass-Throughs

Until the advent of the indoor shopping mall, in the 1960s and 1970s, leases were typically "gross"; that is, the tenant paid rent to the landlord with no additional separate expenses. Indoor shopping malls, which required significantly more maintenance such as air conditioning for large interior spaces, proved to be expensive and risky for landlords, particularly if their tenants had lengthy leases with no CAM.

Accordingly, landlords adopted variable-CAM charges, in which tenants are charged for common area maintenance, taxes and insurance at an estimated monthly amount, and at the end of the year the landlord reconciles its statements and determines if the tenant has over or underpaid.

Trend Toward Fixed and Capped CAM

In recent years, tenant demands for more predictable pass-through charges, coupled with fluctuating energy and operating costs, have forced landlords to reconsider the variable expense approach and move toward a flat, or fixed, CAM.

One major mutual benefit of fixed CAM is that practically eliminates the need for lease audits, which are expensive and time consuming for both parties. In addition, lease negotiation time may even be reduced through fixed CAM, since operating expense provisions frequently require extensive discussions between landlord and tenant.[1]

The primary benefit of fixed CAM to the tenant is a definite handle on expenses for the year. The tenant also knows that the landlord has more of an incentive to run the property efficiently. This can, however, work to the tenant's disadvantage if the landlord, in favor of saving money, neglects the property. The tenant should carefully review the flat CAM charge prior to signing the lease to ensure that it is not being overcharged.

From the landlord's perspective, fixed CAM is a riskier proposition; if expenses suddenly increase, the landlord cannot recover from the tenants and must foot the bill itself. To counter this, landlords may opt to exclude certain expenses from the fixed CAM, such as taxes, insurance, and utilities. This approach is referred to as "capped CAM" because the landlord is capping the expenses on certain controllable items such as landscaping, cleaning, and other building maintenance expenses. During lease negotiations, the landlord may set out certain a mutually agreed upon fixed increase in CAM each year during the term in order to offset the risk of a sudden increase in expenses.

The current trend of shorter lease terms of 5 years (as opposed to 10-20 year leases in the 1960s and 70s) is also in the landlords' favor, as it lessens the risk if expenses outweigh the fixed CAM charges; the landlord will be able to re-let the space with a higher fixed CAM rate in a shorter amount of time. Fixed CAM also alleviates the

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[1] Rowlands, William. Fixed CAM/Gross Leases – An Emerging Trend? *Lang Michener LLP Real Estate Brief Fall 2005*.

landlord from the administrative hassle of calculating variable CAM and preparing year-end reconciliation reports.

Trend Toward Lifestyle Centers

Keeping in tune with the desire for more predictable and less expensive CAM charges, the growing popularity of lifestyle centers indicates that tenants are seeking cost effectiveness in new venues. Lifestyle centers are typically open air shopping centers, with upscale retail, restaurants, coffee shops, but no traditional "anchor" store. Some larger lifestyle centers include office space or a residential component. Although the base rent at a lifestyle center might be comparable to that at a more traditional mall, the operating expenses are significantly lower (up to one-third) because the lifestyle center does not have a roof or large conditioned space. The International Council of Shopping Centers reports that the number of lifestyle centers in the United States quadrupled from 2002 to 2004 (30 centers to 120) and that 10-20 new centers will have opened in 2005 and 2006.[2]

Trend Toward "Green Building"

Since earth-friendly residential construction evolved in the 1970s, the trend toward green building for commercial, industrial, and retail outlets is increasing at a steady pace. A June 2005 article in *Urban Land* declared, "...the green market is expanding into the mainstream and may well surpass traditional construction within a

[2] Bhatnagar, Parija. Not a mall, it's a lifestyle center. *CNNMoney.com.* January 12, 2005. <http://money.cnn.com/2005/01/11/news/fortune500/retail_lifestylecenter/>

decade."[3] There are numerous green office projects under construction right now, including the Goldman Sachs headquarters in Lower Manhattan, New York, which broke ground in November 2004. When completed in 2009, it will be one of the largest office buildings in the United States with a gold LEED rating. A LEED rating, which stands for Leadership in Energy and Environmental Design, is a building rating system established by the U.S. Green Building Council. Among other attributes, it evaluates a building's water and energy efficiency, raw materials, air quality, and the overall impact on the environment.

Environmentally conscious tenants and increasingly stringent governmental standards are behind the push for green buildings, but studies have shown that building green has benefits for landlords too. *Green Value*, an international study of green building published in October 2005, found that such buildings can earn higher rents, attract tenants more quickly, reduce operating and maintenance expenses, reduce tenant turnover, and even provide business benefits to tenants.[4] These benefits to tenants include a more productive work environment, less absenteeism, lower operating costs, and an overall improved morale in the workplace. Despite these benefits, the landlord should strive to keep the cost differential between a traditional leased space and a green leased space as small as possible.

Maintenance of a green building requires special agreements between landlord and tenant, or, a "green lease." The lease must provide incentive for both the landlord and tenant to reduce energy costs and maintain high environmental standards, which causes a minor dilemma as to the type of pass-through provision. With fixed CAM, the

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[3] Rose, Jonathan F. P. The Business Case for Green Building. *Urban Land*. June 2005.
[4] Green Building News November 2005. November 14, 2005. <http://oikos.com/news/2005/11.html>

tenant has no incentive to keep the costs down, whereas in a triple net lease, the landlord has no incentive to keep costs down. Some examples of clauses included in such a lease are[5]:

- Targets for environmentally friendly usage of water and electricity by the tenant (i.e. tenant must turn off lights when not in use)
- For tenant improvements, a landlord can designate certain types of building materials or techniques so that the improvements are in line with the green building philosophy.

There are varying degrees of green leases; some put the onus of environmental compliance on the landlord, while others share the burden between both parties. In any case, a party considering a green lease should take the following into account[6]:

- Since there is a higher level of shared responsibility, both parties must have a subsequently high level of trust and belief in the other.
- Green lease provisions must be enforceable with damages outlined for instances of noncompliance.

Although the jury is still out on green building, it is clear that landlords and tenants alike are exploring the possibilities of new types of leasing relationships.

[5] Environment Quarterly Editorial: August 2004. *Freehills.* <www.freehills.com/publications/publications_1223.asp>
[6] Rose, Jonathan F. P. The Business Case for Green Building. *Urban Land.* June 2005.