

## Real Estate Title Insurance & Construction Law

### Common Area Maintenance Costs

Moving to a fixed cost model?

By Jeffrey Hugh Newman

For years, tenants have accepted the inevitability of increasing common area maintenance (CAM) costs as a necessary part of doing business. This pill was often made easier to swallow, for shopping-center retailers, by an environment of increasing sales. However, two factors have shaken most tenants from their CAM-cost stupor: lackluster sales and spiraling increases in CAM costs.

These circumstances have caused CAM costs to become unacceptably high, in terms of a percentage of sales. In fact, from 2004 to 2008, while average sales per square foot at enclosed malls increased by approximately 14 percent, CAM costs per square foot at the same locations rose approximately 30 percent. The resulting squeeze on profits has caused justifiable consternation in retailers' executive suites. Consequently, upper management has found ways to control the CAM-cost

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drivers, resulting in an analysis of current leases and the creation of several strategies in dealing with current and future leases.

Virtually every shopping center lease, with the exception of a free-standing store in which a single occupying tenant assumes responsibility for all aspects of its tenancy, contains a clause identifying the manner in which the landlord will manage the common area of the shopping center.

Most leases will also specify the manner in which the landlord may charge the tenant for the costs of operating the common area. Usually, the landlord will estimate the annual cost, charge the tenant a monthly estimate and, shortly following each year, render a final bill that will call for a payment or credit depending on the full year's actual costs as compared to the aggregate of the monthly estimated payments.

However, even in the circumstance of a tenant with the right to audit the landlord's CAM-cost records, landlords may not proactively seek to control costs since audits don't "audit proactively." Moreover, the landlord is not accountable for CAM costs if they are passed through to the tenant. Tenants perceive this absence of accountability, and the fact that many landlords do not necessarily perceive the benefit (nor, perhaps, the obligation) of controlling CAM costs, as increasing the

likelihood of escalating charges.

Ironically, most leases give the landlord an incentive to increase CAM costs, because the landlord's administrative fee is usually calculated as a percentage of CAM costs. Thus, increases in CAM costs increase the landlord's administrative fee, regardless of whether additional administrative costs are actually incurred by the landlord in operating the common areas of the shopping center. Even more ironic is the fact that the less time a landlord spends on administrative duties, the more likely CAM costs will increase.

For example, suppose a landlord fails to expend the effort and expense to obtain multiple competing bids from contractors to repave the parking lot. The lack of a sufficient number of competing bids may well result in a higher price for the paving costs and, as a result, higher administrative fees for the landlord.

#### Controlling CAM Costs

On the other hand, most landlords realize the benefits of controlling CAM costs. They recognize that tenants have limited occupancy cost dollars to spend in connection with a lease. If a tenant has "x" dollars to spend per square foot, a landlord can obtain greater base rent as the CAM-cost rent component decreases. The ability to increase base rent allows the landlord to increase its capitalizable base for a sale or refinancing of the property.

Therefore, reducing CAM costs is

simply good business for landlords. For example, a 10-cent decrease in the landlord's administrative fee for each dollar of decrease in CAM costs (assuming a 10 percent fee), enables the landlord to raise base rent (presumably by one dollar), and results in a potential multiple-dollar increase (\$12.50, assuming an 8 percent "cap rate") in proceeds upon a sale or refinancing of the property.

As demonstrated above, not only is it economically sensible for landlords to seek to reduce and control CAM costs, it also just makes good business sense.

Interestingly, to avoid the inordinate amount of time and expense in not only negotiating these multiparagraph complex sections of leases, but the time, expense and negative impact on the landlord-tenant relationship in addressing CAM-cost issues after the lease becomes operative, some landlords have moved to a fixed CAM charge with a fixed annual escalator. While in some areas special weather conditions may be carved out and dealt with separately, just as security was initially carved out by some in the aftermath of Sept. 11, the fixed CAM-cost approach is working.

As indicated earlier, while tenants want the lowest rent available, the real hurdle is the percentage of total occupancy costs they will allow themselves to bear based upon their sales projections. By moving to a fixed CAM cost model (or a hybrid), tenants can obtain greater cost certainty in their leases. At least while sales visibility remains murky as we slog through this recession, there is all the more reason to seek CAM-cost certainty.

To further illustrate, assume a landlord reduces annual CAM costs by \$1 million, thereby reducing a 5-percent administrative fee by \$50,000 per year. However, say the landlord can increase the minimum rent by 100 percent of the CAM-cost savings. Hence, minimum rent increases by \$1 mil-

lion. Suppose the landlord seeks to sell its shopping center (five years later) at a cap rate of 10 percent. The sale would then create an additional \$10 million of sales proceeds (10 x \$1 million), in return for "relinquishing" \$500,000 of administrative fees (\$50,000 x 10). Of course, if the landlord can only "transfer," say, 50 percent of the CAM-cost savings to minimum rent, the additional sales proceeds would be \$5 million (\$500,000 x 10) in consideration for "losing" \$50,000 per year of CAM costs.

However, regardless of whether landlords want to control CAM costs, tenants are starting to demand that they do. Many tenants are studying the fine print of their leases to ascertain their ability to require landlords to be more efficient and economical in the operation of the common areas.

Often, leases are silent as to the tenant's rights with respect to CAM costs. When leases fail to provide tenants with the means of verifying the accuracy and propriety of the CAM costs presented by their landlords, tenants will usually ask for supporting data only when there appear to be egregious errors.

#### **The *Rock Creek* Ruling**

While some landlords comply with requests for such data, including requested audits of the underlying books and records, others refuse unless the lease expressly provides for such rights. There is scant judicial guidance on the issue of a tenant's right to obtain verification and/or independently audit CAM costs where the lease is silent. However, in *P.V. Properties, Inc. v. Rock Creek Village Assoc. Ltd. Partnership*, 549 A.2d 403 (Md. Ct. Spec. App. 1988), the lease in question provided for neither a right of verification nor audit, but the court construed the relevant lease provisions and found an implied obligation of good faith

and cooperation, such that it granted the tenant's request for the equitable remedy of an accounting (i.e., verification of CAM costs).

The *Rock Creek* court found the equitable concept of accounting, which is normally applicable to fiduciaries, to apply under the facts of the commercial landlord-tenant CAM dispute at issue. The court then combined that finding with contractual concepts of good faith and fair dealing, which a growing number of courts employ to engraft concepts of reasonableness into leases that do not otherwise require a landlord to act reasonably. Thus the court found an implied duty on the part of the landlord to account to the tenant for CAM charges incurred by the landlord. However, the *Rock Creek* court is the only court to do so in a real estate context. While *Rock Creek* has not been overruled despite its reference to a fiduciary obligation, it has only been followed in trust and estate cases dealing with the obligations of actual fiduciaries to account to beneficiaries and, where referenced in other cases, has been distinguished.

Interestingly, courts have engrafted the implied duty to be reasonable, or the concept of good faith and fair dealing, into a number of different types of cases involving real estate issues, ranging from mitigation of damages to withholding of consent in a subletting context.

Results of this nature comport with equity and, as in the *Rock Creek* case (albeit a stretch to reference a fiduciary standard), merely provide the tenant with the opportunity to assure itself that the landlord is simply performing as it should. Clearly, the *Rock Creek* court recognized the concept of accountability "for the keeper of the books" as the quid pro quo for another's relinquishing control. But, a tip for the wise tenant — get the right to audit in writing! ■