

UNDERSTANDING COMMERCIAL LEASES

Knowing the ins and outs of your lease can save your company time and money.

Justin Daniels

A thorough understanding of all aspects specific to a commercial lease is essential to successfully investing in real estate or running your business. Commercial property owners determine whether or not to purchase a commercial building based in large part on the lease revenue such a building generates. Business owners who lease space understand that their single biggest fixed operating cost is making lease payments every month. Yet landlord and tenants alike avoid understanding most commercial lease provisions beyond the rent payment, until the misconception costs them thousands of dollars along with a hefty legal bill. This article focuses on repair responsibilities and common area maintenance charges, two areas that cause disagreement between landlords and tenants. These superfluous disagreements divert time, attention and resources away from conducting business.

In the industry, the triple-net lease commonly is understood as requiring that the tenant make all repairs. However, when acquiring a building with existing tenants, lease review during the due diligence period takes on added importance. Most buyers cover the lease payment, term, renewal option and rent increase provisions, but they overlook the repair responsibility provisions. As a result, one landlord belatedly discovered that the \$10,000 cost to replace his tenant's HVAC unit solely was his responsibility. Another landlord was unaware that he was responsible for repaving the entire parking lot until he received written notification from the tenant requesting the repair. These horror stories illustrate that commercial real estate buyers should recognize that no two leases are alike, and any can contain latent liabilities that often spring to life after the acquisition, effectively draining away the buyer's cash flow

and profit. Put another way, if the buyer knew that he was responsible for these likely repairs and that such repairs could cost tens of thousands of dollars, those facts would, at a minimum, serve the buyer as a negotiation tool when discussing a purchase price adjustment with the seller. The buyer would also factor these potential liabilities into its initial offer as it would increase the projected operating costs of the property.

Especially in older buildings, tenants overlook the implications that arise when they are responsible for most repairs. In those cases, HVAC replacement, parking lot repavements, and damage arising from employees can cost businesses thousands of dollars that adversely impact the bottom line. Tenants should realize that a thorough walk-through prior to executing a lease, coupled with a reasonably negotiated repair provision, significantly can reduce the likelihood that a tenant will face the cost outlays associated with these types of repairs. Tenants who not only incur the extra time and cost to perform a thorough walk-through but also raise the repair issue will often be rewarded by a landlord willing to be responsible for, or at least contribute to, potential problems uncovered in the walk-through or after review of an ambiguous lease repair provision.

Common area maintenance charges (CAM charges) is another area that repeatedly causes problems between landlords and tenants. CAM charges are the operating costs of the building that can include utilities, water, real property taxes, maintenance and landscaping. CAM charge calculations can be determined in several different ways and can impact the kind of information a commercial building acquirer may request during the due diligence process. Due diligence may reveal that CAM charges are calculated as the increase of the current year's operating expenses over a fixed base year, where the fixed base year may be from several years past when the seller first entered into the lease. The buyer, therefore, will want the building's operating expenses from that year in order to properly calculate the CAM charges going forward. A landlord overlooking this detail will find itself unable to calculate the CAM charge and hard pressed to retrieve the base year oper-

ating expenses from the seller.

Real property taxes can also result in increased operating expenses to a landlord that cannot be passed on to the tenant. CAM provisions often express that the tenant is responsible for all real estate taxes. However, in certain lease provisions, the tenant's responsibility for the real estate taxes can be capped with any excesses becoming the landlord's responsibility. A property owner recently asked that I review his lease, as he thought he could pass on a \$7,000 real property tax increase to his tenant. He was shocked when I advised him that there was a cap and that he was responsible for all additional real estate taxes. As a result, \$7,000 in profit was wiped out by one sentence in the lease.

On the other hand, tenants commonly make the mistake of not knowing what expenses are included in the CAM charges. Furthermore, tenants do not realize that they have the right to review and audit such operating expenses when an unexplained and exorbitant increase occurs. Two major scenarios consistently occur with tenants and CAM charges. First, tenants who are unaware of what expenses comprise the CAM charge usually fail to budget for the real property taxes, landscaping, water and general maintenance charges. Second, tenants receiving a notice of increased CAM charges pay them without understanding that they have a contractual right to receive an explanation of the increase.

In the final analysis, landlords and tenants alike need to pay close attention to the finer points of a commercial lease. Repair and CAM charge issues are just two of the myriad issues that usually arise during a commercial lease. Businesses that wait until a problem occurs assure themselves that resolving it will cost at least **three times** what it would have cost them upfront to spend extra time and money identifying and resolving potential problems. The different commercial lease provisions are like the tentacles of an octopus, each having the ability to reach into and remove the profits from an unsuspecting landlord or tenant.

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