WHEN LANDLORDS OVERREACH

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INTRODUCTION

In the early 1970s, when the economy was in free fall and office space was cheap, many landlords entered into long term leases at fixed rents with negotiated increases in the base rent. Many of those landlords lost their buildings as increases in their operating costs (in particular fuel cost and real estate taxes), fueled by inflation, outstripped the rents generated by their buildings. Today's commercial leases avoid that result by including provisions that either (A) directly pass through to a tenant a percentage of the building's operating costs and real estate taxes (a "pass-through clause") or (B) require the tenant to pay as additional rent its share of increases in operating expenses and taxes over base year expenses and taxes ("escalation clauses") or (C) increase the base rent through use of some form of index, such as the Consumer Price Index or, in New York City, a "Porter's Wage" clause (now rarely used). Some landlords offer fixed percentage increases in base rent (e.g. 2% per annum increases) in lieu of operating expense charges, which has the advantage of simplicity but can prove quite expensive for leases of any significant size.

Pass-through clauses are typically found in retail leases, but are also used in office leases in many jurisdictions. Escalation clauses are typically used in office leases. Tenants leasing office space in multiple jurisdictions understand that, market considerations aside, base rents tend to be cheaper in jurisdictions in which the landlord directly passes through ALL operating expenses and more expensive in jurisdictions in which the tenant pays only its share of increases in operating expenses. That differential reflects in part the fact that additional rent payable for operating expense pass-throughs considerably exceeds additional rent payable for operating expenses under escalations clauses.

Escalation clauses themselves tend to fall into two categories. The first is the "expense stop" formula in which the lease sets out a "base" number or "stop" for operating expenses/taxes, that in theory should reflect the landlord's cost per rentable square foot for operating expenses and real estate taxes when the lease is signed. In subsequent years, the landlord again determines its cost per rentable square foot and, if the cost has increased, the tenant pays an amount equal to the increase in the landlord's costs per rentable square foot multiplied by the number of rentable square feet leased by the tenant. The second category of escalation clause, which should achieve the same result, is one in which the landlord compares its total operating costs/ real estate taxes for each year of the lease against the landlord's total costs for the "base" year (usually the year in which the lease is signed) and the tenant pays its proportionate share of the increase in those costs for each year.

The theory behind charging tenants for a share of the landlord's operating expenses and real estate taxes is simple. It is to preserve the landlord's profit throughout the term of the lease. If the base rent includes a 10% profit component at the beginning of the lease and the landlord's operating expenses rise each year over a 10-year term with no corresponding increase in rent, by the end of the lease term the landlord's profit margin may have been reduced to zero and the landlord even may be operating at a loss.

ALTERNATIVES TO OPERATING EXPENSE INCREASES AND PASS-THROUGHS

Fixed Base Rent Increases. The simplest method of dealing with increases in operating expenses and real estate taxes is to project increases and set the base rent at a number that will cover the projected increases. This has a lot of appeal because it eliminates disputes, audits, and administrative paperwork. It may hurt the tenant economically because the landlord will have to set the rent at a high enough number to cover expected increases and then some (subject to any market limits on rent). For a short term lease (1-5 years), the landlord may be willing to take that risk, because even if the landlord has made a mistake in its projections, the mistake will be relatively short-lived. It would be unusual, however, even in that scenario, for a landlord to forego passing though real estate taxes.

Percentage Increases in Base Rent. Operating expense clauses are often an administrative headache for landlords and tenants. If ten different tenants have negotiated ten different operating expense clauses, then theoretically the landlord needs to generate ten different operating expense calculations (although rarely does). For the tenant to confirm that the landlord has properly calculated operating expense charges, it must generally hire an auditor, audit the landlord's records within the applicable time periods, and involve its own personnel in evaluating the results of the audit and subsequent negotiations or litigation with the landlord. Tenants particularly dislike operating expense clauses because tenants like certainty. They like to know what the rent will be, and it is impossible to determine what rent will be if the lease rent is subject to increase based on changes in operating expenses and/or real estate taxes.

For tenants leasing small spaces, especially in large buildings, it will be almost impossible to police the operating expense clause in a way that's effective and economically feasible. Auditing the landlord's numbers for a small lease takes the same amount of time as auditing the landlord's charges for a multi-floor lease, making it difficult to locate an auditor willing to work on a cost-effective basis. The cost of paying the auditor on an hourly basis will generally be too great to justify the audit for the tenant and the recovery on a contingent fee arrangement will be too small to justify the audit from the auditor's perspective. Accordingly, the tenant may wish to consider negotiating for fixed percentage increases in the fixed rent (perhaps 1.5-3% per year) in lieu of an operating expense clause. Although this may make sense for a tenant leasing less than 5,000 rsf of space, such a formula will probably over-compensate the landlord for increases in operating costs because operating expenses constitute only a portion of the landlord's costs that are covered by the rent. Debt service and real estate taxes are the other major categories of expense that are covered by rent. Although operating expenses vary from year to year in response to increases in living costs, debt service does not and real estate taxes generally follow a trajectory that relates more to market influences than increases in maintenance costs. Accordingly, if one-third of the base rent is allocable to operating expenses, and the landlord increases the base rent by 3% per year in lieu of an including an operating expense clause, the landlord is likely to make a significant profit on that 3% annual increase in base rent unless operating costs increase by a factor significantly greater than 3%. The tenant may be willing to accept this scenario in favor of achieving certainty, but at some point, the cost will be too great. The way to determine if a fixed percentage increase makes economic sense is to have the tenant's broker run a series of projections over the term of the lease of the estimated cost to tenant of a percentage increase in operating expenses and of an operating expense clause.

Note that even where the landlord has proposed a fixed rate of increase in base rent in lieu of an operating expense clause, the lease (except for the shortest term leases) is likely to include a real estate tax pass-through or escalation and perhaps also an insurance or other specific pass-through.

Consumer Price Index. Base rent can also be increased by an index in lieu of an operating expense clause. A commonly used index is the Consumer Price Index, which measures increases in various costs on a monthly basis, many of which may have little bearing on the landlord's operating costs. A Consumer Price Index clause provides for the increase of the base rent on an annual basis in the same percentage that the Consumer Price Index increases (either from year to year or over the base year index). Often the parties negotiate a cap on CPI increases and sometimes a minimum annual increase.

The Bureau of Labor Statistics of the United States government publishes the Consumer Price Index tables. There are a number of different tables, including tables that measure increases in costs incurred by urban consumers.(the CPI-U tables, which relate to household costs of most residents of urban areas); and household costs of urban wage earners and clerical workers (the CPI-W tables). Each of those groups is in turn divided into sub-indexes. Some are locally oriented (e.g., CPI-U (New York, Northern NJ-Long Island)); some are more national in scope (e.g., CPI-U (U.S. City Average)). Landlords generally prefer a local index. National tenants generally prefer a nationally oriented index, which tends to be less volatile. The CPI does not include in the costs measured the cost of real estate. Accordingly, it is disconnected from the real estate market and should not be used as a means of increasing rent in connection with the exercise of an option.

If the Consumer Price Index is applied to the entire rent, it presents the same issue (from the tenant's perspective) that an annual fixed percentage increase presents. The CPI is a measure of increases in expenses, but only a portion of the rent is allocated to operating expenses. Accordingly, if the CPI is applied to the entire rent, the landlord has built a profit component into the escalation. A method of dealing with this is to calculate the increase by applying the CPI increase to a percentage of the base rent, rather than the entire base rent. Perhaps in recognition of the distorting effects of the CPI clause, and also in recognition of the potential volatility of CPI increases (since the CPI is basically measured against consumer costs, which tend to be volatile), it is not unusual to provide for minimum rent increases and/or maximum base rent increases when a Consumer Price Index is used to escalate rents.

Porters Wage Index. Another index that was once commonly used in New York City was the Porter's Wage Index. For each penny increase in the hourly rates paid to unionized building porters, the base rent was increased by an amount equal to the penny increase in hourly rates multiplied by the square footage of the premises. Because the hourly rates were calculated to include fringe benefits, the calculations were often convoluted, subjective and difficult to audit.

The Porter's Wage escalation also became notoriously expensive and landlords encountered substantial resistance from tenants. As wages flattened, the Porter's Wage also became less potentially profitable to landlords, and is now rarely used.

REAL ESTATE TAXES

Introduction. Almost all leases contain a real estate tax pass-through clause or escalation. With a pass-through the tenant pays its percentage share of all of the building's or shopping center's real estate taxes. Under an escalation clause, the tenant pays its percentage share of increases in real estate taxes over the base year taxes.

From the tenant's perspective, real estate taxes are a relatively innocuous form of escalation or pass-through in the sense that the concept is a fairly simple one (tenant pays its share of real estate taxes and assessments or of increases in same) and relatively easy to audit – the information is usually available in the public record. Although relatively simple in concept, in high tax jurisdictions, real estate taxes can be a major driver of rent increases over the term of a lease. For both pass-throughs and escalations, key issues include: (a) the calculation of tenant's percentage, (b) the definition of "real estate taxes," and (c) whether there are situations in which increases in real estate taxes should not be passed on to the tenant.

If the real estate tax clause is an escalation clause, additional key issues to consider are (a) the choice of the base year, (b) the choice of the first "comparison" year, (c) whether there are any existing factors that may artificially reduce base year real estate taxes, (d) whether there are any factors that may artificially inflate "comparison" year real estate taxes, and (e) the impact of tax reduction proceedings.

Tenant's Share or Percentage. If the tenant pays its "percentage" of real estate taxes, how should that percentage be calculated? A landlord-favorable lease (such as a small space lease in a large shopping center) might provide that the tenant's percentage equals the leasable area of the premises divided by the "leased" area of the building or shopping center. Such a formulation favors the landlord because if vacancies develop, the tenant's percentage will increase (as the denominator – the leased area -- shrinks) so that the existing tenants at any given time always cover 100% of the landlord's real estate tax expense. If the shopping center develops significant vacancies, such a clause can become very expensive. Since the underlying concept of real estate tax pass-throughs and escalations is to cover the landlord's increases in *operating expenses* as they relate to real estate taxes, and not to fund the landlord's vacancy costs, such a formula goes far beyond the original intent of such clauses. One method of handling a "leased area" formula is for the tenant to negotiate a cap on its tax liability or a provision that the "leased area" will, for purposes of the computation, never be less than "__"% of the "leasable area" of the Shopping Center. In the latter case, the tenant's tax liability will increase as the shopping center's vacancies increase, but the vacancy increase will be capped.

For a small shopping center or a retail tenant who has greater leverage, the percentage may instead by a function of the rentable or leasable area of the premises as compared to the "leasable" area of the building or shopping center. In such leases, tenant's percentage will remain constant notwithstanding vacancy changes in the shopping center.