Additional Rent and its Hidden Costs – A Tenant's Perspective

Tenants understand the terms "minimum rent" and "percentage rent". They also understand that in a typical commercial lease there is an obligation to pay an assortment of additional costs (usually termed "additional rent"), including: the utilities consumed in their premises; the realty taxes applicable to their premises; business taxes if levied on the business being conducted from their premises; promotion and advertising charges; heating, ventilating and air conditioning ("HVAC") charges; and a contribution to common area costs ("CAM Costs"). It is, however, the extent of charges within additional rent, primarily CAM Costs, which can catch the unwary tenant and cause a significant increase in the tenant's rent.

Landlords use broad, generic language in their offers to lease to describe CAM Costs, with the devil being found in the detail of the lease. To the tenant's detriment, once the offer is signed by both parties, it is legally committed. From a business perspective, (since there is now both a legal and psychological commitment to the deal), there is little latitude or fortitude to negotiate.

Case law provides some assistance to the tenant. For example, in ***R. Denninger Ltd. v. Metro International General Partner Canada Inc. and Lehndorff Property Management Ltd., 8 O.R. (3d 720***, the landlord did not specify that there was a fifteen percent administration fee attributable to CAM Costs. The tenant refused to sign the lease with such an administration fee and the landlord relied on the "net net" lease clause from the offer. Fortunately for the tenant the courts found that such a charge was not part of the net net concept and was not exigible. Other cases have restricted such provisions See ***Dylex Ltd. v. Premium Properties Ltd. [1996] O. J. No 2165*** regarding capital taxes.

However, a carefully crafted offer will state that the tenant is obligated to pay its proportionate share of the landlord's costs and expenses attributable to the ownership, administration, operation, management, maintenance, improvement, insuring, cleaning, policing, supervision, rebuilding, replacement and repair of the shopping centre and realty taxes on the shopping centre, plus an administration fee equal to fifteen percent (15%) of such costs and expenses. For a prudent tenant, this general wording should raise the following questions:

i. What costs from this basket of costs should be excluded?

ii. What is the tenant's proportionate share?

iii. What substantiating documentation must the landlord provide to confirm these costs?

EXCLUSIONS FROM CAM COSTS

When acting for a tenant, the following is my list of exclusions from CAM Costs.

- any ground rent, mortgage or other finance charge payable by the landlord;

- any management fee charged for the management of the shopping centre;

- interest on debt or the capital retirement of debt,

- any cost or expense incurred by the landlord in discharging its obligations with respect to other tenant/occupants of the Shopping Centre,

- any cost incurred by the landlord or any other tenant/occupant of the Shopping Centre as a result of a breach by the landlord or any tenant of its respective obligations contained in its lease/license;

- any amount payable by the landlord as a result of a breach by the landlord, or those in law for whom it is responsible, of this agreement and/or Lease or another tenant's/occupant's lease/license, or arising as a result of the negligence of the landlord and/or those in law for whom it is responsible;

- leasing and marketing costs/fees, agents/brokers commissions or charges, solicitors fees or any other fee, salary or expense incurred by the landlord including any tenant allowance or inducement in leasing, marketing all or any part of the Shopping Centre or in negotiations or disputes with other tenants/occupants or prospective tenants/occupants of the Shopping Centre;

- any amount for which proceeds of insurance are available to the landlord or would have been available had the landlord taken out the required insurance;

- any cost covered by a warranty or indemnity;

- the capital cost of any repair or replacement to the base building, including the structural components, the roof, foundations, mechanical/electrical system and plumbing system;

- any depreciation of the base building or the amortization of repair or replacement costs thereof;

- any tax on the income of the landlord, or the large corporations tax or the minimum corporate tax of Ontario if any, or any capital tax;

- any administrative wage and/or salary of head office personnel of the landlord;

- any goods and service tax exigible upon any cost included in operating costs, such that there will not be any duplication of the GST;

- any cost resulting from any hazardous or toxic substance being found in the Shopping Centre, and

- any penalty or interest charge exigible against the landlord.

Additionally, the landlord should covenant that all contracts entered into for such costs be with arm's length companies and at competitive markets rates.

HVAC COSTS:

HVAC costs are included in CAM Costs where the tenant's premises are served from a central plant, which is common in an enclosed shopping centre. However, in strip plazas and some enclosed malls, the tenant has its own roof mounted HVAC system, with wording in the lease requiring the tenant to maintain, repair and replace the HVAC unit and system serving its premises. The tenant must be careful of these provisions, otherwise the tenant could be in for an exceptional cost, the cost of replacing the system or paying the cost of a major repair. By the typical wording of a lease, the tenant is responsible for the repair or replacement cost of such unit at any time during the Term. Thus, for example, if during the last month of a ten-year term the HVAC unit requires replacement, the tenant would incur this significant cost without the opportunity to recoup this cost, since according to GAAP it would only be able to depreciate a portion of this cost. At the same time, in the writer's opinion, the landlord is unjustly enriched by having a new unit in place for which it has not expended any money, which saving could be factored into the rent for the replacement tenant.

From the tenant's perspective the responsibility to replace should not arise unless the cause of the HVAC repair or replacement was the negligent act of the tenant. However, it is appropriate for the tenant take out or contribute to the cost of a biannual HVAC maintenance contract.

Assuming such a maintenance contract is in place and there is no negligence by the tenant, then the tenant should only be responsible for a specified portion of HVAC repair and replacement costs per annum (i.e. $2,000.00), with any cost in excess of such amount being borne by the landlord, or if the unit requires any repair or replacement, the cost of repair or replacement should be paid for by the landlord, with the tenant contributing to the annual depreciated amount, (with the cost depreciated over the useful life of the HVAC unit (I suggest fifteen year to avoid future argument). Thus, if on the first day of the last year of a term the HVAC unit was replaced, the tenant would be responsible to pay only 1/15th of the replacement cost.

PROPORTIONATE SHARE RATIO

Most landlords use some form of weighted ratio to determine the tenant's proportionate share. For example a tenant leasing 2,000 square feet in a 400,000 square foot plaza may think that its proportionate share is 2000/400,000 or 1/200th. This tenant would think that it is therefore only responsible for 1/200th of all CAM Costs. Practically, this is seldom the case. The landlord will try to exclude from the 400,000 square foot denominator some or all of the following:

> (a) kiosks; (b) storage areas; (c) free-standing buildings; (d) premises with an area of more than 10,000 square feet; (e) space used or intended for use as theatres or cinemas; (f) offices that are not at or near the level of a mall and do not have direct enclosed pedestrian access to and frontage on a mall; (g) bowling lanes and space used or intended for use as recreational, sports or health facilities; (h) space used or intended for use by governmental or public offices, agencies or services or charitable organizations; and (i) mezzanine areas inside Rentable Premises.

From the tenant's perspective, the first item of concern in this list is paragraph (d), premises with areas in excess of 10,000 square feet, (and for the purpose of this paper such tenants are hereinafter called "Major Tenants"). The landlord's argument for justifying this exclusion is that Major Tenants act as a draw for the general public to the centre, that Major Tenants understand this, and therefore, the landlord must offer reduced rents to attract Major Tenants. This seems reasonable where the threshold is 30,000 or more for a supermarket, or 60,000 square feet for a department store, but not for stores with an area in excess of 10,000 square feet. (I have seen this threshold as low as 6,500 square feet).

If the landlord wants to rely on this argument, the corollary should be a co-tenancy clause, such that if a Major Tenant ceases to carry on business in the centre, then the tenants who have subsidized that Major Tenant through their contributions to CAM Costs, should have an abatement in their rent (or a right of termination) if the premises occupied by the Major Tenant become vacant and are not replaced by a similar tenant within a specified period of time. I would also recommend that the area specified in (d) be qualified to refer only to ground floor area, (save if in a multi level development,

where this area can be over several floors, provided there is direct access to such store from the common mall).

The lease will likely provide that, before calculating the tenant's contribution to CAM Costs, the landlord will deduct therefrom the Major Tenants' contribution to CAM Costs. A smart landlord will allocate a preponderance of the rent it wants to charge a Major Tenant to that tenant's minimum rent, thereby reducing that Major Tenant's CAM Cost contribution, knowing that the shortfall in that this shortfall will be picked up by the other tenants of the centre. This also has the benefit of increasing the landlord's income for the centre.

There is no justification for (a) kiosks and (b) storage areas. Both occupants of these premises consume the common area costs in the centre, but do not provide any benefit to the in-line tenant. Items (e) theatres or cinemas and (g) bowling lanes, are not necessary as they are included under (d).

From (h) a landlord should exclude liquor stores, beer stores, and government agencies such as Motor Vehicle registration offices, as these occupants are probably paying full rent.

GROSS UP OF THE TENANT'S AREA

Note that some landlord's also gross up the area of the tenant's premises (as is done with office leases) to pick up a proportion of the common areas, such as utility rooms, garbage rooms and administration offices. What is the justification for this? Further, some landlords will also attribute a minimum rent to the area that is being grossed up, and require the Tenant to pick up this cost through operating costs.

INCREASE IN MINIMUM RENT FOR MAJOR TENANTS

Certain landlords will try and increase a tenant's minimum rent by one or two dollars a foot for each Major Tenant in the Centre. This is, in my opinion, unreasonable.

SUBSTANTIATING DOCUMENTATION

Most leases require the landlord to provide the tenant with an annual statement of CAM Costs, which statement is a reconciliation of the previous year's CAM Costs. What is lacking is the detail. Usually the lease provides only for a statement signed by an officer of the landlord or a statement signed by the landlord's auditor, without backup. A prudent tenant should:

i. require the landlord to provide substantiating documentation;

ii. permit the tenant the right to audit the landlord's books (which right is identical to the landlord's right to audit the tenant's books for determining gross sales in calculating percentage rent;

iii. require the landlord to provide this statement within a reasonable period from the end of each fiscal year. Certain landlords have failed to provide a reconciliation for years, yet each year they can increase the rent. The Tenant should request a certain time frame for such statements, failing which the tenant should not have its CAM Costs increased until such reconciliation is received; and

iv. try to cap CAM Costs for the first year, and thereafter pay increases based upon a formula (i.e. increases in CPI). Even with a new centre, a landlord has a good idea of what its CAM Costs will be.

Why is it that landlords will permit a tenant only a sixty day period to challenge their annual statement of CAM Costs, while giving themselves an indefinite period of time to review the tenant's books for the gross sales calculation?

CONCLUSION

The reality is that leases are drafted by landlords for their benefit. Therefore, a prudent tenant should review its documentation carefully and understand all of its obligations and costs before signing on the dotted line. At least then, even if the landlord refuses to amend its document, the tenant has entered into the agreement with its eyes wide open.

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