Escalation Issues in Commercial Leases

By Abraham P. Friedman

Except for very short-term leases, almost every commercial lease executed today contains a rent escalation clause. The trend is for landlords to create a lease in which the tenant pays a fixed return to the landlord plus reimbursement of many capital and expense items, such as taxes, insurance, maintenance, and operations. In effect, this trend applies the concept of the "net lease"—which formerly applied only to the leases of a freestanding structure to a single tenant—to all commercial leases. This article examines some of the common methods of increasing rent during the lease term as well as common issues that the parties should consider when negotiating a rent escalation provision.

Rent Escalation Methods

Landlords and tenants might structure a rent escalation clause in several ways. These methods include increasing the rent by

- a fixed amount each year,
- the percentage increase in either the consumer price index (CPI) or another inflationary index, or
- the actual increase in the landlord's operating, maintenance, and insurance expenses and real estate taxes.

Abraham P. Friedman is of counsel in the Houston, Texas, office of Winstead Sechrest & Minick, P.C.

Some standard leases use a combination of two or more of these methods.

The most common escalation clause passes through to the tenant any increase in operating expenses and real estate tax. Landlords choose this technique for good reason. Because it is the most frequently used escalation provision, most tenants will accept it, and, of the available escalation methods, it is the most accurate reflection of a landlord's increased operating costs, because its computation should create an increase exactly equal to those costs. Yet it is the most complex of the three escalators. Numerous aspects of the provisions of the clause create unknown and unreasonable risks for tenants.

Some leases have the tenants pay a percentage share of the total operating expenses for the operating year, but the more typical clause requires payment by each tenant of its percentage share of the *increase* in costs for the operating year over a base amount. When the increase is over a base amount, setting that base is crucial to the tenant. It is also important to provide for certain adjustments to the base and the increases so that the landlord is not reimbursed twice for the same expense or for an expense that is not properly included as an operating expense. The use of carefully negotiated definitions, as discussed below, is critical.

The key for any tenant is to limit unknown exposures, prevent the landlord from including unreasonable costs, and control unfixed costs. A lease accomplishes these goals by providing for realistic bases, excluding those costs that should not be reimbursable, adjusting the bases and costs if necessary to prevent unreasonable increases, capping the increases, and requiring the landlord to keep certain records that are subject to audit by the tenant. Most leases also provide that the rental will never decrease.

Common Area Maintenance Overcharges

For many years the operating expense and tax clause, or common area maintenance (CAM) clause, ostensibly requiring reimbursement for the increase in the project's operating expenses, has been a profit-making aspect of the lease.

Eight of the most common lease expense overcharges include

1. capital costs incorrectly allocated as repairs;
2. parking garage expenses not offset by the parking revenue;
3. costs specifically excluded by the lease but lumped into "miscellaneous" expenses (such as travel and entertainment expenses);
4. tax abatements, rebates, or refunds not passed through or credited to tenants;
5. double billings for utility service paid by an individual tenant but also included in a general utilities category;
6. accountants' fees for preparing the landlord's tax returns;
7. failure to pass through expense reductions as credits; and
8. build-out expenses for a specific tenant.

This CAM "abuse" in the industry is confirmed by lease auditing, which often uncovers overcharges. It is not always easy for the tenant to know when it has been overcharged, however, because the typical annual CAM statement contains little detail. Many times the statement simply includes a single amount to be paid. More frequently, the statement includes some additional detail such as the total expense, the tenant's proportionate share, and a breakdown of the expenses in a few major categories such as management fees, utilities, taxes, maintenance, and the amorphous black hole "other." Tenants cannot tell what is or is not included and whether or not the charges conform to the previously negotiated lease agreements.

Often the expense bill has little detailed explanation of specific expenses, and no copies of bills or other records are included. The tenant is able to identify glaring errors only, such as the wrong percentage share being applied, a cap that is not applied, or, if the tenant has access to the base year numbers, large percentage increases that will require further review.

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Problems with Definitions

"Property"

The most significant definitional problem with operating expenses for the tenant relates to the definition of the landlord's property to which the pass-through charges apply. Normally, the landlord's property should be defined as the office, warehouse, or shopping center building or complex of buildings, any adjoining parking garage that serves the building, the real estate on which these improvements are situated, and private streets and easements, all of which are owned by the landlord. In some instances, though, the adjoining private streets or easements accessing the building are jointly owned or shared with third parties. In those circumstances, street and easement expenses should be shared proportionately with the third party.

The tenant should receive a breakdown of the real estate—that is, property descriptions, rates, and values—as of the commencement date of the lease. The tenant should determine whether the building is assessed at its full value or at a lesser sum in the event that the building is not fully completed or fully occupied. If the building is not completed, and therefore is assessed at less than its full value, the tenant will be subject to an escalation, even though the tax rate did not change, simply because the building was not fully assessed. The concept also holds true for an adjoining parking garage. Also, if any improvements are added to the building or parking garage after the commencement date of the lease or if any adjacent property is acquired, taxes on those items should be disclosed.

The tenant will want to determine if the landlord includes taxes on its on-site personal property and, if so, whether this should be the landlord's overhead or an item that should be passed through to the tenant.

"Operating Expenses"

Issues of interpretation also can arise over the types of costs included in "operating expenses." The tenant should determine, for example, whether staff salaries and benefits are included in the landlord's operating expenses. The tenant should determine staff members' functions and whether they are considered part of the landlord's overhead. Certain staff members may be used on other properties owned by the landlord. The prudent lessee will find out whether the landlord has a third-party manager that manages multiple properties for the landlord and others. This type of an arrangement will have a direct effect on pass-throughs to tenants.

Similarly, the tenant should address its responsibility for assessments for public improvements, such as street paving. The following are two possible lease approaches:

1. If the assessment is payable in installments, then only those

installments becoming due and payable during the term of the lease should be passed through to the tenant.

2. If the improvement has an estimated useful life, then the assessment should be allocated or amortized over its useful life, which may extend beyond the lease term. Extension options should also be considered.

"Taxes"

A final area of concern is the tenant's liability for taxes. For example, if the landlord contests taxes and obtains a reduction or a refund, the tenant should share the benefit as a future credit or, if the term is at its end, receive a refund instead. Some states permit a tenant to contest property taxes. E.g., Tex. Tax

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Code § 41.413. Texas provides that a real property tenant that is contractually obligated to reimburse the landlord for taxes imposed on the property is entitled to protest a determination of the appraised value of the property, if the landlord does not file a protest. A single protest is limited to either the landlord or the tenant. The tenant is considered the owner of the property for the purposes of the protest. The landlord is required to send the tenant in a timely manner a copy of the notice of the property's re-appraisal. Id. Although this right exists as a matter of statute in Texas, in Texas and elsewhere a provision should be included in the lease requiring the landlord to provide the tenant with a notice of the tax appraisal. From a practical perspective, unless the tenant occupies a substantial portion of the property, it may not be cost effective for the tenant to protest the appraisal.

With some minor exceptions, assessments payable in installments should be determined on an accrual basis. Each taxing authority has its own timetable for the payment of real estate ad valorem taxes. The taxes may be determined on a fiscal or calendar year basis and may be payable quarterly, semiannually, or annually with a penalty for late payment. The tax reimbursement clause should dovetail with this actual timetable.

Audit Rights

The tenant's principal defense to escalation clauses is a right to examine records to verify calculations. Not only will the CAM statement fail to provide enough information to uncover an overcharge, but it also will be costly to get the needed information elsewhere. The lease should require a certification by some principal of the landlord for the correctness of operating costs and taxes. To audit the landlord's books, the tenant may need to fly its own accounting team to the city where records are maintained. To avoid this, the CAM clause should state that records relating to operating expenses must be available in the city in which the property is located. The tenant should have at least 180 days to audit the landlord's records to verify the correctness of the escalations. The landlord also should maintain sufficient records to support any billing for escalations and also a budget to disclose how estimated escalations would be billed to the tenant.

The tenant may find it necessary to hire an outside firm to spend several days exhaustively poring through the landlord's books, but first should consider whether costs of this audit could easily exceed any hoped-for recovery. A small tenant cannot afford to conduct an audit. Even if small tenants can afford to audit, outside auditing firms are generally not interested in conducting an audit unless the space is 10,000 square feet or more; this is double the size of the average tenant space.

In addition to the costs, tenants must fight through the lease provisions designed to prevent the tenant from finding and recovering overcharges. Landlords make tenant audits difficult by imposing limits on the tenant's right to audit, including

- limiting the period the tenant can audit (for example, audits must be done within 30 days of receiving a CAM statement),
- not paying for an audit's costs even if there is an overcharge,
- prohibiting an audit unless the expenses increase by a fixed percentage over the prior period, and
- prohibiting a tenant from hiring anyone to review records on a contingent fee basis.

Tenant's counsel should negotiate for language providing that, if the tenant pays an increase with which it disagrees, it should recover interest in any action brought to dispute the amount of the increase. If an error is determined, based on an audit conducted by the tenant that reflects more than the allowed percentage of error, then the landlord should pay the cost of the audit and tenant's legal fees, with some cap on the amount.

Base Operating Expenses

Base operating expenses can be approached in two ways. In some instances, the landlord selects an expense stop, expressed in dollars per rentable square foot of area. If there is a base operating expense stop, the tenant should attempt to negotiate a stop as close as possible to the amount equal to current expenses, adjusted to assume 95% occupancy. This approach would require that the landlord provide a detailed analysis of the components that make up the expense stop. In some instances, leases provide for individual stops for each component of base operating expenses, such as taxes, insurance, management fees, utilities, and repairs. If there are such individual expense stops, the landlord can obtain a windfall when some expenses go up while others go down. Under a single stop, the landlord recovers no more than the overall actual increase. If individual caps are used, the tenant should negotiate for the benefit of decreases in any individual component.

Grossing Up

"Grossing up" is a method to avoid having phantom expenses passed through to tenants. Grossing up takes the actual operating expenses during the relevant period, such as the calendar year, and increases those expenses to an amount that would have been expected to have been incurred if the building were fully occupied. Grossing up both the base year and the adjustment period is important to both the landlord and tenant. If the base year was not grossed up, and the base year occupancy was low, the tenant could pay for the increase in occupancy rather than an increase in expenses. If in the adjustment period the occupancy rate fell below the base year occupancy, then the landlord would have to pay part of the increased actual cost because the total of the tenant's pro rata share would have decreased.

Expenses should be divided into those that are occupancy-dependent and those that are nonoccupancy-dependent. The distinction is related principally to those expenses that vary based on occupancy rates. In an actual gross up, adjustments should be made only for those costs that are affected by occupancy levels. A gross up to 100% occupancy is unrealistic; in most cases 90% to 95% is acceptable. The following example illustrates the gross up issue.

Assume that the tenant occupies 10% of a new office building that is only 30% occupied when the lease goes into effect. In the base year, the operating expenses are $250,000 ($50,000 is occupancy-dependent and $200,000 is nonoccupancy-dependent). In the second year of the lease, the building's occupancy rate rises to 80%, and the total operating expenses increase to $370,000 ($120,000 is occupancy-dependent and $250,000 is nonoccupancy-dependent). If expenses are not grossed up, the tenant will be liable for 10% of the $120,000 increase, or $12,000, over the base year.

If the expenses are grossed up, the following occurs: $50,000 of the base year's operating expenses are occupancy-dependent. If the building was 90% occupied in the base year (rather than 30%), the landlord's estimated occupancy-dependent expenses would be $122,500. Add $122,500 (occupancy-dependent operating expenses) to $200,000 (nonoccupancy-dependent operating expenses), and the total is $322,500. For the second year, $120,000 of the operating expenses are occupancy-dependent. If the building were 90% occupied in the second year, the occupancy-dependent expenses are estimated to be $130,000. By adding $130,000 (occupancy-dependent operating expenses) to $250,000 (nonoccupancy-dependent operating expenses) the sum is $380,000. Subtract $322,500 (the grossed up operating expenses for the base year) from $380,000 (the grossed up operating expenses for year two) and the difference is $57,500. The tenant is charged its proportionate share (10% of $57,500), or $5,750. This figure compares favorably with the payment due if the gross up had not been undertaken ($12,000).

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CPI Indexing

As discussed above, a second popular method of calculating rent increases is to use an index. One of the common indexes used in rental escalations is the CPI, but this index, if not carefully analyzed, can cause significant problems. The CPI measures the average change in the prices paid for a market basket of goods and services. These items are purchased for consumption by the two groups covered by the index: "All Urban Consumers" (CPI-U) and "Urban Wage Earners and Clerical Workers" (CPI-W).

The following are general guidelines to consider when developing an escalation agreement using the CPI:

- Define clearly the base payment (rent) that is subject to escalation.
- Identify precisely which CPI index series will be used to escalate the base payment. This should include the population coverage (CPI-U or CPI-W), area coverage (U.S. City Average, West Region, Chicago, and so forth), series title (all items, rent or primary residence, or otherwise), and index base period (1982–84=100).
- Specify a reference period from which changes in the CPI will be measured. This period is usually a single month (the CPI does not correspond to a specific day or week of the month) or an annual average. There is about a two-week lag from the reference month to the date on which the index is released (for example, the CPI for May is released in mid-June). The CPIs for most metropolitan areas are not published as frequently as the data for the U.S. City Average and the four regions. Indexes for the U.S. City Average, the four regions, three city-size classes, ten region-by-size classes, and three major metropolitan areas (Chicago, Los Angeles, and New York) are published monthly. Indexes for the remaining 23 published metropolitan areas are available only on a bimonthly or semiannual basis. Visit the Bureau of Labor Statistics web site (Question 16 in the FAQs at www.bls.gov/cpi/cpifaq.htm) for information on the frequency of publication for the 26 metropolitan areas.
- State the frequency of adjustment. Adjustments are usually made at fixed time intervals, such as quarterly, semiannually, or, most often, annually.
- Determine the formula for the adjustment calculation. Usually the change in payments is directly proportional to the percentage change in the CPI index between two specified time periods. Consider whether to make an allowance for a cap that places an upper limit to the increase or a floor that promises a minimum increase regardless of the percentage change (up or down) in the CPI.
- Provide a built-in method for handling situations that may arise because of major CPI revisions or changes in the CPI index base period.

See U.S. Dep't of Labor, Bureau of Labor Stats., *How to Use the Consumer Price Index for Escalation*, available at www.bls.gov/cpi/cpi1998d.htm (last visited Apr. 20, 2006).

When choosing an index series on which to base an escalation clause, the parties should be aware of several important factors:

- As noted above, the CPI is calculated for two population groups: All Urban Consumers (CPI-U) and Urban Wage Earners and Clerical Workers (CPI-W). The CPI-U represents about 87% of the total U.S. population and is based on the expenditures of all families living in urban areas. The CPI-W is a subset of the CPI-U and is based on the expenditures of families living in urban areas who meet additional requirements related to employment; more than one-half of the family's income has to be earned from clerical or hourly wage occupations. The CPI-W represents about 32% of the total U.S. population.
- There can be small differences in movement of the two indexes over short periods of time because differences in the spending habits of the two population groups result in slightly different weighting. The long-term movements in the indexes are similar. CPI-U and CPI-W indexes are calculated using measurement of price changes for goods and services with the same specifications and from the same retail outlets. The CPI-W is used for escalation primarily in blue-collar cost-of-living adjustments (COLAs). Because the CPI-U population coverage is more comprehensive, it is used in most other escalation agreements.
- The 26 metropolitan areas for which BLS publishes separate index series are by-products of the U.S. City Average Index. Metropolitan area indexes have a relatively small sample size and, therefore, are subject to substantially larger sampling errors. Metropolitan area and other sub-components of the national indexes (regions, size-classes) often exhibit greater volatility than the national index.
- The U.S. City Average CPIs are published on a seasonally adjusted basis, as well as on an unadjusted basis. The purpose of seasonal adjustment is to remove the estimated effect of price changes that normally occur at the same time and in about the same magnitude every year (price movements because of the change in weather patterns, model changeovers, holidays, end-of-season sales, and so forth). The primary use of seasonally adjusted data is for current economic analysis. In addition, the factors that are used to seasonally adjust the data are updated annually. Also, seasonally adjusted data that have been published earlier are subject to revision for up to five years after their original release. For these reasons, the use of seasonally adjusted data in escalation agreements is inappropriate.

See id., www.bls.gov/cpi/cpi1998d.htm (last visited Apr. 20, 2006).

Escalation agreements using the CPI usually involve changing the base payment by the percentage change in the level of the CPI between the reference period and a subsequent time period. This calculation is made by first determining the index point change between the two periods and then the percentage change.

The Bureau of Labor Statistics of the U.S. Department of Labor publishes a number of other indexes, including the Producer Price Index (PPI), the Employment Cost Index, and the Gross Domestic Product Deflator. From a tenant's perspective, the PPI does not fluctuate as widely as any of the consumer indexes. Details of the PPI may be found at www.bls.gov/ppi/home.htm.

Computing Floor Area

Determining the percentage of operating expenses and real estate taxes to be paid by the tenant is also quite complex. This is generally based on a percentage determined by dividing the area used by the tenant by the total area of the building. The Building Owners and Managers Association (BOMA) has published a standard method for measuring floor area in office buildings. American National Standards Institute, Inc., *Standard Method for Measuring Floor Area in Office Buildings* (June 7, 1996). In addition to physically measuring the space, it is important to understand the definitions. Particular difficulty arises in defining "Gross Building Area," "Floor Rental Area," "Floor Usable Area," "Usable Area," "Floor Common Area," "Basic Rental Area," "Building Common Area," and "Rentable Area." Each term has a complex definition set out in the BOMA manual. Rental Area and Building Rental are the definitions used to calculate the percentage of escalations passed through to the tenant. Significant dollars are involved in selecting the definition and making the calculation. A full floor tenant's space is measured differently from the space of a smaller tenant. Elevator lobbies, restrooms, equipment rooms, columns, and common areas are factored into the calculations. An architect or engineer with access to "as built" plans should verify the determinations.

Conclusion

Tenant lawyers need to be conversant with the complexity of rent escalation clauses and should request modifications to typical lease language to protect their clients. Two excellent publications for details on clauses and forms for drafting commercial leases are Gary Goldman, *Drafting a Fair Office Lease* (American Law Institute–American Bar Association Committee on Continuing Professional Education, 2d ed. 2000), and Milton R. Friedman, *Friedman on Leases* (Practicing Law Institute, 5th ed. 2004). Ultimately, though, the ability of the tenant to obtain modifications is largely dependent on the tenant's financial capabilities and the landlord's need for a specific tenant. ■