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CAM Expenses in Commercial Leases: Cumulative versus Non-Cumulative

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During commercial leasing negotiations, landlords and tenants will often extensively negotiate the terms of a cap on the controllable operating expenses under a lease. Often, however, the issue of whether the cap will be cumulative or non-cumulative is glossed over in the lease language. Based on whether the cap is cumulative or non-cumulative, there could be a significant difference in the actual impact of the cap on expenses.

To take a step back, typical in commercial leases of shopping centers and office buildings, Common Area Maintenance ("CAM") expenses, also referred to as "operating expenses," are a separate, additional rent expense for day-to-day operations of the property. These expenses are either controllable, which are expenses a landlord has influence over, or uncontrollable, which are those expenses that are dictated by a third party and thus outside of a landlord's control. For example, controllable operating expenses may include anything from parking lot maintenance and window washing, to trash removal and landscaping. On the other hand, uncontrollable operating expenses include property taxes and building insurance.

During lease negotiations, tenants often request a "cap," on the controllable operating expenses from year to year (typically in the range of 3% to 10% annually). For example, if tenant and landlord agree on a 5% annual cap on controllable operating expenses, this means that tenant's controllable operating expenses the following year will not exceed 105% of the cost from the prior year. These caps on CAM expenses can either be negotiated as cumulative or non-cumulative. While both set a ceiling on the annual increase in controllable operating expenses that can be passed on to a tenant, one is often favored by landlords and the other favored by tenants.

Landlords prefer a cumulative cap on operating expenses because the "cumulative" nature carries on annually such that landlord can recover any unused portion of the cap from prior years. To illustrate, let's say that landlord and tenant agree to a 5% annual cumulative cap. In year two, the

CAM expenses increased by 3%. Therefore, 2% of the cap was unused. In year three, the CAM expenses actually increase by 10%. Tenant's responsibility in year three would not be capped at the 5%; rather, tenant's responsibility would be capped at 7%, which includes the unused portion from year two. If the cap in the prior example had been non-cumulative, tenant's responsibility would have been capped at 5% in year three, regardless of the fact that expenses only increased by 3% of the allowed 5% in year two, therefore preventing landlord from recovering any unused CAM increases from prior lease years. This illustration shows how a cumulative cap on operating expenses provides landlords with more flexibility, and why tenants generally desire non-cumulative caps to avoid unexpected rental increases.

"Operating expense caps, weather they're cumulative or non-cumulative, continues to be one of the more complex terms Landlord and Tenant face in lease negotiations," state Jordan Bohannon, Vice President, Avison Young. "However, the concept is important because it addresses the extent of Landlord and Tenant responsibility if there is an increase in controllable operating expense costs for the property that year." The next time you are negotiating the terms related to operating expenses in a lease, you should carefully read the operating expense provision to make sure that the language matches your intended outcome.

If you have any questions about commercial leasing, please reach out to one of the Lowndes Leasing Lawyers.