Leasing Insights: Caps on CAM

07.18.11

When parties negotiate a cap on common area maintenance ("CAM") pass-throughs to the Tenant, they often state it in simple terms in the Letter of Intent, such as "a 6% cap on CAM." However, nuances in this limitation can make a substantial difference in both the Tenant's and the Landlord's bottom line. The timing of such a cap, whether the cap is cumulative, compounding or both, and what specific charges the cap does or does not apply to, are all important concepts that should be addressed by the parties, preferably at the Letter of Intent stage of negotiations.

People tend to think of a cap on CAM as applying after the first year of the Lease Term. This may be appropriate for fully operating shopping centers; however, if the shopping center in question is still under construction, being built in phases, or completed but empty with limited operations, starting a cap after the first year's costs will likely result in a much lower pass-through amount than intended by the Landlord. For example, taxes on a shopping center being built in phases may increase in stages as well. If a cap on tax pass-throughs commences after the first year of the Lease, but taxes then substantially increase 2 years later due to the continued improvements in the shopping center, the Landlord will not be able to readjust the basis after which the cap is applied, and the Tenant's pass-throughs will be limited to calculations based on the lower tax amount. Accordingly, the Landlord should consider if the cap should instead apply after the second or third year of the Lease Term, after the first full year during which the shopping center is fully constructed and fully operational, or something similar.

Landlords and Tenants may also disagree as to whether a cap should be cumulative or compounding. A cumulative cap is one that takes into consideration the cumulative percentage charged over a period of time, so that a Landlord can charge more than the cap in certain years so long as this is balanced out with charging less than the cap in other years. For example, if a Tenant has a 6% cumulative cap, then the Landlord could increase CAM by 4% in one year, but then increase it by 8% in another year, for an average increase of 6%. This way a Landlord is not penalized by having a low CAM year, but can instead then make up the difference in years where costs may be unusually high, so long as the average increase does not exceed the cap. A compounding cap is one that calculates increases by including all of the prior increased amounts, instead of just calculating each year by the specified percentage. For example, if the CAM charged to the Tenant for the first applicable year is $10.00 per square foot, and the Tenant has a 6% compounding cap, then in the second year the CAM charged cannot exceed $10.60 per square foot, and in the third year the CAM charged cannot exceed $11.24 per square foot. However, if the cap was non-compounding then the CAM charged in the third year would have been limited to $11.20 per square foot (i.e., by calculating 12% over the initial $10.00 instead of 6% over the prior $10.60). This may appear to be a small difference, but for a large Tenant with a long term Lease, these amounts can add up.

Lastly, caps on CAM are frequently limited to capping only certain costs. The theory behind excluding certain costs from a cap is that costs that are not within the Landlord's control should not be subject to the cap, while costs that are within the Landlord's control should be capped. However, Tenants often assume when they are told they will receive a cap on CAM that this will include all CAM costs. The parties should address this early on to avoid subsequent issues that may have big implications on each party's projected costs. Some common exclusions to a cap on CAM are taxes, insurance, utilities, and snow and ice removal. Some other exclusions that may also be requested are capital expenses (to the extent they have been included in CAM to begin with), security, labor expenses, expenses as a result of any act of terrorism and "any other cost beyond the reasonable control of Landlord."