

What's Escalatable?

By: Michael ("Mickey") M. McClune, RPA®, FMA®

So ... we all know that the quickest way to deal with the annual process of computing and reconciling the CAM/OE Escalations for a property/building and billing its tenants is to take the total operating expenses for the year, add in the capital expenditures that weren't in the "Operating Expense" section of the financials, and then for each tenant's billing subtract from that result each tenant's offset amount (e.g., the tenant's Base Year Amount, Stipulated Expense Amount, etc.), multiply that result by their percentage share, subtract the total of their Monthly CAM Impounds paid during the year, slap that result on the tenant's Rent Statement, and mail it to the tenant. All the expenses incurred by the property/building are included, very little time has been spent (i.e., "wasted") on the assignment, and other tasks can now be focused on.

But is that the "right thing to do"? If so, why were all those hours spent making carefully-constructed operating expense lease provisions, not to mention the lengthy "exclusions list" provisions? Isn't this a lease-mandated process requiring the care and diligence of the landlord just as is required for maintaining the property/building, safe-guarding the tenants' security deposits, etc.? And, are those "personal" expenses that have been "expense reported" to the property/building (e.g., obtaining a real estate license or designation, expensive lunches/dinners with a friend, etc.) really something that the tenants should pay for? How about all that special work to clean-up that horrible vacant suite that's been used for building storage so that it can now be leased out for an additional rental income stream (that goes in the landlord's pocket and not the tenants')? If you were a tenant in that building who owned your own company and paid your bills with your own money, how would you feel about having to pay for stuff, while typically being denied the right to review details of the billing by the way, that sometimes: (i) have nothing to

do with your lease and even possibly the property/building; (ii) are personal to the landlord or are part of their "investment" that will earn them a healthy return (that isn't shared with you); and (iii) are contradictory to provisions that you specifically negotiated into your lease with the consent and agreement of the landlord? Is that process really "ethical" from a personal and professional perspective?

No ... of course NOT! It's neither the "right thing to do", nor is it ethical or professional.

The CAM/OE Escalation process must be done carefully, taking whatever amount of time is needed to "do it right" per the lease provisions and "industry standards", computed in accordance with the procedures specific to the type of CAM/OE Escalation mandated by the lease, and including only those expenses that are "escalatable" while fully excluding all expenses that have been deemed "non-escalatable" not only by the lease but also by those same "industry standard procedures".

Because there are a variety of lease types (e.g., *Industrial Triple Net, Full Service Gross, Modified Gross – Base Year, Modified Gross – Expense Stop, Modified Gross – Stipulated Base Amount, Modified Gross – Office Triple Net*), there are a variety of methodologies that must be followed, all of which is too much to discuss herein. However, fundamental and common to each is "what expenses are allowable/escalatable", and by extension, "what expenses are not allowable/escalatable"? The purpose of this article, therefore, is to review this latter area.

Escalatable Expenses

"Escalatable expenses" include those specified in a tenant's

lease as well as those imputed by the “general wording of the lease”. For this latter group, the typical wording at the beginning of a lease’s “Operating Expenses” provision provides the guidance: “*Operating Expenses include ... costs paid or incurred by Landlord ... for the operation, maintenance, management, and repair ... of the Building ...*”. This general wording is important in that it defines a number of important things relating to escalations:

- “... costs paid or incurred by the Landlord ...” means: (a) that only “real” costs and not made-up costs can be included (i.e., landlords can not just add a fictitious amount that wasn’t actually incurred/paid in that particular year somewhere in the expenses and have the tenant pay its share of it); and (b) included / escalated costs can only be those associated with (i.e., “incurred” for) that particular year and not for another year (e.g., if costs were “incurred in” / “associated with” 2007 but their payment was made in 2008, under the “Base Year Concept with a Gross Up” they must be included in the 2007 escalations and they are not allowed to be in the 2008 escalations – however, under a “NNN” lease they would generally be included in the 2008 escalations);
- “... for the operation, maintenance, management, and repair ...” means that expenses associated with those functions are generally escalatable (subject to any “non-escalatable” provisions as discussed below), while other types of expenditures such as “capital improvements/repairs/replacements”, “expenditures incurred in anticipation of or as a result of a property sale, or financing, or re-financing” are not; and
- “... of the Building ...” indicates what the escalatable costs can be associated with. For example, if the “Building” is part of a multi-use “Project”, then only the costs associated with this “Building” are escalatable to the particular tenant with this lease language, while all the other costs associated with the other portions of the multi-use “Project” would not be escalatable to this particular tenant.

Non-Escalatable Expenses

“Non-escalatable expenses”, on the other hand include those expenses specified in a tenant’s lease in its various “... not includable ...” listings, as well as other expenses sprinkled throughout in various other provisions of the lease (e.g., those expenses that are to be charged to specific tenants or are to be absorbed solely by the landlord, etc.). The proper computation of a tenant’s operating expense escalation for any particular calendar year requires that

each and every expense of each calendar year be individually reviewed (e.g., usually by an item-by-item review of each expense in the property’s year-end general ledger) for “escalatability” and that expense items that are expressly “non-escalatable” according to the lease, or are non-escalatable according to industry standards, are to be excluded from the escalated totals billed to the tenant. The inclusion of such expenses would violate the lease agreement and ethics of real estate professionals.



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Mickey McClune is the President, Broker, and the Managing Principal of MKC Asset Management, Inc., a Long Beach-based commercial real estate property management firm. As President, Broker, and Managing Principal, Mickey is responsible for all activities of the firm, including new business acquisition, oversight of all property management activities, and the performance of all of the firm's commercial real estate consulting services. He is an experienced commercial real estate property management, asset management, and leasing specialist with an extensive institutional owner and corporate user background.

Mickey began his career in commercial real estate in the early 1980's with the preeminent national real estate firm, LaSalle Partners (now Jones Lang LaSalle), as its General Manager for all of the office and industrial properties that it had acquired in the Los Angeles and Ventura County areas, and as its Asset Manager for various client portfolios in the Western U.S. While at LaSalle, he was recognized for numerous accomplishments both by the company and the commercial real estate industry. In 1993, he left LaSalle to form his own property management company, New America Asset Management Services, where he was the President and the senior partner of this Long Beach-based commercial real estate property management firm. In late 1997, LaSalle acquired NAAMS and its two million square foot management portfolio, and Mickey then served as LaSalle's Regional Vice President for the Southwestern U.S. In 1999, he joined EPS Solutions, a national corporate services consulting firm, as a Director of Real Estate Services. While at EPS Solutions he assisted property owners with their property acquisition due diligences, their properties' annual Operating Expense Escalations, and with the abstracting of their tenant leases, and he assisted tenants by performing over 50 CAM/OE Escalation Audits for them of their landlords' billed rent charges. In 2001, he again formed another commercial real estate property management firm,

MKC Management Services, where he served as CEO and senior partner. Soon thereafter, MKC merged with New York City based Newmark & Company Real Estate and became its California-based Asset Management Group. In mid-2003, Mickey was instrumental in merging Newmark & Company's California-based Asset Management Group's operations into a new start-up entity that then became known as RiverRock Real Estate Group. At RiverRock, Mickey was its Senior Managing Director, where he established all of the firm's property management systems, oversaw selected property management teams, and was responsible for all of the firm's consulting business. In early 2006, Mickey left RiverRock to start MKC Asset Management.

Over the course of his 25+ year career in commercial real estate property management, Mickey has personally managed and leased well over 18 million square feet of commercial office, industrial, and retail space, abstracted over 5,000 leases, performed over 400 annual CAM/OE Escalations for landlords' buildings, saved clients well over \$4 million in cash savings, received four (4) "Management Excellence Awards" from LaSalle Partners, was a LaSalle Partners' "Manager of the Year", and was awarded by BOMA of Greater Los Angeles four (4) "Building of the Year Awards" (in "100,000-250,000 SF" and "Over 500,000 SF" categories) and two (2) "Special Achievement Awards" including one for "Overall Design Improvement".

Prior to entering the real estate industry, Mickey was commissioned as an officer in the United States Air Force and spent 11 years in the USAF and private industry with Hughes Aircraft Company specializing in the business management of major aerospace industry programs.

Mickey has a California Real Estate Broker License, and is RPA and FMA certified by the Building Owners and Managers Institute. He is a past Chairman of the Board and past member of the Executive Committee and Board of Directors of BOMA of Greater Los Angeles, has served on BOMA Orange County's and BOMA California's Executive Committees and Boards of Directors, and on BOMA International's Board of Governors and Strategic Planning Task Force. Mickey graduated from the University of Southern California with a Bachelor of Science degree in Civil Engineering and a Master of Business Administration (MBA) degree.