Avoiding the CAP Trap

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A common misconception we hear from clients when discussing possible lease audit candidates is, "These leases are capped so we don't worry about them." However, often the opposite is true. In fact, leases that have NTE (Not to Exceed) Caps may need more review to determine if landlord has accurately billed the tenant.

An NTE Cap should never be confused with a fixed amount or fixed percentage increase. The NTE Cap can be a source of overcharges to the tenant rather than the protection from an overcharge, which it was initially designed to be. This type of cap can come in many different variations depending on how the lease is negotiated. It may be calculated on the base year, or on the prior year. It can be tied to a percentage or an external derivative such as a Consumer Price Index or Porters Wage. The cap may begin on the first year, or in future years. The increase may be cumulative and/or compounded. It is important for a lease administrator to read the lease carefully to avoid applying the cap in an incorrect manner.

The following identifies some NTE and straight caps, and looks at how the tenant may be at risk of overcharges from them:

Stated First Year with a Year over Year Percentage Increase:

Lease Language for a stated dollar amount for the first year with a percentage increase year over year may read as follows:

Lease commences on July 1, 2008 and the states that CAM for the first Lease Year will not exceed $5.00 per square foot and increases 5% annually over the prior year thereafter. The lease defines the lease year as July, 1 through June 30th.

Based on the above sample lease language, a landlord statement on a calendar year basis may bill the tenant $5.00 per square foot for the period of July 08 through December 08 (reduced by the amount of time that the tenant did not occupy the space) then begin charging the 5% increase of $5.25 from January 09 through December 09.

However, this is incorrect. For starters, just because there is an NTE Cap does not mean the landlord can just apply the maximum cap amount in the first year. The first year states it is not to exceed $5.00. **The tenant should always review the first year in detail considering its affect on all future year amounts.** In addition, if the lease does not have the language, *"not to be less than the prior year,"* the tenant may want to review each year in detail to make sure the costs have not decreased from the prior year.

The Landlord is also applying the $5.00 cap for the partial year instead of the entire lease year as defined in the lease. The lease year is defined in the lease as July 1 through June 30th. There still remains a $5.00 per square foot NTE Cap for the second half of the lease year for the period January through June 2009. If the landlord is billing the $5.25 per square foot, and the 2009 cap is exceeded, there could be a sizable overcharge to the tenant for 2009. This overcharge will increase if landlord is billing the maximum cap from year to year. The same can be true if the lease reads, "first full calendar year," instead of a defined lease year. In this case, the landlord should bill the partial year at the capped amount or actual depending on how the landlord's decides to bill, and the first full calendar year beginning January 2009 is billed at the $5.00 NTE cap amount. The increase of 5% would start on the following calendar year beginning January 2010.

Controllable v. Non Controllable:

Another variation of the NTE Cap allocates expenses between controllable and non-controllable. The reasoning behind this is that some expenses are under landlord's control and some are not, and those that are not should not fall under the cap parameters. One might see the same lease language as above, but including *"controllable costs are capped expenses and non-controllable expenses will be billed at the actual amounts. Non-controllable expenses are defined as utilities, insurance and snow plow."*

The statement is now divided into two billable parts, one controlled by the cap and one that is not. With this separation of expenses, the reviewer not only needs to be concerned with first year, partial year and possibly subsequent years calculation, but also how the landlord is applying expenses to the controllable and non-controllable expense accounts. With this type of cap, the landlord may be motivated to move expenses from the controllable to non-controllable if the cap for the controllable expenses has been exceeded. A detail review of both controllable and non-controllable expenses is needed to determine if the tenant is being billed appropriately.

Anchor contribution or other deductions from the landlord's billing statement, when combined with a controllable and non-controllable NTE Cap has the potential to be misapplied. The risk is when the Controllable NTE Cap has been exceeded, and landlord applies the bulk of the anchor contribution or deduction to the controllable NTE Cap, creating less or no benefit for the tenant.

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Cumulative and Compounded Caps:

Two types of caps that are often confused for each other are the cumulative and compounded caps. A cumulative cap allows the landlord to make up the difference in the future years between the actual percentage increase and the stated capped percentage. The compounded cap allows the landlord to add the annual incremental amount calculated from the cap to the following year.

To illustrate a Cumulative Cap using our above lease language but substituting "and increases 5% over the prior years actual cost on a cumulative basis:" Year 1 the landlord will charge $5.00 per square foot. In Year 2, if actual costs increase 3% over year l, landlord can carry forward the remaining 2% (5%-3%) and charge up to a 7% (2% plus 5%) increase in year 3. If year 3 actual cost were less then the 7%, then landlord could carry the difference to Year 4 and so on.

Cumulative caps can also be calculated as a percentage of actual expenses applied over the base year amount rather than the prior year. The cap is a limit that determines what percentage the landlord can charge over the base year; In this case, Year 1 base year is $100,000 (based on first year actual cost unless stated in the lease). Year 2 the landlord could pass through up to $5,000 (100,000 * 1.05% = $105,000 – 100,000 = $5,000); Year 3 the Landlord could pass through expenses over the base year up to $10,000 (100,000 * 1.10% = $110,000 – 100,000 = $10,000) and Year 4 $15,000, and so on. Again, because this is cumulative cap, if the actual expenses fall short in any one year, landlord can make the difference in a percentage increase over the 5% in the future years when actual exceeds the annual 5% increase.

Compounded Caps work similar to cumulative caps but carry the calculated amount forward for the next calculation. For example, for a cap calculated on the base year and using our above lease language but substituting "and increases 5% annually over the base year's actual cost on a compounded basis." Year 1, the base year cost is $100,000, Year 2 the amount the landlord could pass through above the base year would be $5,000 (100,000 * 1.05% = $105,000 – 100,000 = $5,000), However, because the amount is compounded year to year, in Year 3 the amount a landlord could pass through over the base year is $10,250 (105,000 * 1.05% 110,250 -100,000 = 10,250), and Year 4 $15,762.50. This is much like a compounded savings account you might have at a bank. The incremental difference rolls into the following year and is used in the calculation for the future years.

The risk of overcharge for both cumulative and compounded caps are the same regarding verification of the first year, but now there is an added difficulty of tracking the rolled over percentage amount increases from year to year and verifying that the landlord applied it correctly. Specifically with Cumulative Caps, the unused percentage can build significantly over time, and if the landlord's actual cost should spike in any one year, the tenant may be in for a very large unbudgeted expense. **Cumulative caps can also motivate the landlord to increase the actual cost in order to apply the entire unused percentage. This is especially true during the final years of a lease term if there is a large unapplied unused percentage.**

As can be seen from our few examples, caps should not be neglected and can require as much review time as a triple net lease. Tenants must take the time to understand the type of cap they are working with as well as how it is being applied to ensure that they are not being overcharged, and avoid falling into the CAP Trap.