

Triple-Net Leases versus Full-Service Leases

All leases are not created equal

By Sibley Fleming

If your landlord came to you today and offered you a new lease with significantly lower rent, would you immediately sign on the dotted line or would you ask the most important question: is it a triple-net lease or full-service lease?

The differences between a pure triple-net lease and a pure full-service lease are significant. A high-profile plastic surgeon in Beverly Hills recently found out just how different the leases are when his landlord offered him the opportunity to switch from a full-service gross lease to a triple-net lease without determining the difference between the two leases.

The surgeon agreed to sign a triple-net lease only to find out later that the new lease actually increased his monthly rental expenses by 40%.

How did this happen? The monthly rent was, in fact, the same, but the pass-through costs associated with a triple-net lease—utilities, taxes and maintenance—bumped up the surgeon's monthly costs from about \$15,000 to roughly \$21,000, according to Steve Salas, a broker with Madison Partners, a full-service brokerage boutique based in Los Angeles.

"While savvy tenants may understand the difference between a triple-net and a full-service lease, some physicians only find out what they have signed when the additional costs of a triple-net lease are passed onto them in monthly invoices," Salas says.

Understanding lease types

All too often, a landlord or landlord broker will tell an unsuspecting medical office tenant that he is getting a full-service lease, when in reality it's a modified full-service or modified gross lease, which are very similar to triple-net leases. That's why it's important for doctors and practices managers to understand what each lease type should include and what it should not.

Three main lease types:

Full-service lease: This agreement covers all costs of taxes, insurance, maintenance and utilities. The tenant pays a pre-determined lease rate each month and there are no pass-through expenses for operating expenses.

"A pure [full-service] lease is the best of all worlds for a tenant, particularly for a medical office tenant," maintains attorney Dan Brozost, a partner with Raines Law Group based in Beverly Hills, Calif. The tenant only has to write one check per month, and the amount only goes up incrementally over time with the normal progression of rent.

Monthly rent typically rises about 2 to 3% per year (although that's negotiable). The tenant doesn't have to worry about getting hit later for extra costs such as utilities, and the landlord handles all of the maintenance so healthcare providers can focus on building and growing their practices.

Triple-net lease: A triple-net lease, in comparison, requires a tenant to pay a low lease rate while also writing separate checks for other costs associated with operating and maintaining the property. In fact, the "NNN" in a triple-net lease represents the three major "net" costs: property taxes, insurance and maintenance.

With a triple-net lease, the landlord will also pass on utility costs that are not separately metered, as well as all costs related to common area maintenance (CAM). These so-called CAM charges include all expenses involved in maintaining common areas such as water/sewer, trash, restrooms, landscaping, parking lots, fire sprinklers, the roof or anything that all tenants share.

Modified full-service lease: This agreement is far more similar to a full-service lease except that the doctor is typically responsible for paying maintenance, janitorial and electrical, and the landlord passes through increases in operating expenses over the base year, or first year of the lease term.

Find the hidden costs

While a full-service lease can be attractive to busy medical practices, the disadvantage is that only the landlord will benefit from any savings. For example, if the cost of utilities decreases as a result of energy-efficiency improvements to a building, only the landlord will reap any rewards from the decrease. Likewise, if a landlord appeals his tax bill and is able to reduce the building's taxes, the tenant will not benefit in any way.

The same logic follows with triple-net leases. The downside of a triple-net lease is that if expenses go up, those expenses are passed on to the tenant at a higher rate, so he has very little control, confirms Christina Adams, a partner with Chicago-based National Realty Network—Health Care Real Estate Division.

"In this part of the country there was a mild winter last year, so those landscaping and snow removal expenses might have gone down," explains Adams. "The landlord is supposed to pass through the exact expenses."

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Protective provisions

Tenants can include several provisions in their leases to protect them from painful rent increases.

“One thing that tenants can look at, in order to protect themselves from having the landlord pass through everything under the sun, is to make sure the lease contains sufficient audit rights,” says attorney Brozost.

Audit rights allow a tenant to request and review the landlord's operating expense records and dispute anything that looks excessive, which can be assessed by your broker. The language should require the landlord to provide a final statement of operating expenses at the end of the calendar or fiscal year, and upon the tenant's request, provide invoices as well as a detailed explanation of the costs.

While your attorney works to protect you from paying too much from a legal standpoint, your broker should be working on your behalf to lower or cap expenses as well. For example, Adams of National Realty Network routinely asks landlords for a tax stop, a provision that requires all tax costs to be frozen from the base year of the lease and to never increase.

While she admits this tactic is only granted by landlords about 50% of the time, Adams is not reticent about requesting caps for any expense her tenants are expected to pay, including insurance, maintenance and even snow removal. “We will ask for a cap on all building expenses,” she emphasizes.

Adams' efforts are proof that a good broker and a savvy attorney are crucial to avoiding bad leasing decisions. A lease is a long-term agreement, typically 10 years for a medical office space, and it represents a large financial commitment on the part of a physician or medical group. If not executed properly, tenants can find themselves stuck in situations that do not work from their cash-flow or business perspective.

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