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Cracking the code on triple net leases and how to avoid surprises on your next deal

JOSEPH HEINS SPECIAL TO THE RBJ

You've seen the podcasts and the YouTube videos constantly touting triple net leases as the "passive" way to invest in commercial real estate without the hassle of running a property. "They're simple and easy!" "You can simply buy a property, sign a lease and watch the rent checks roll in every month."


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But nothing is ever that easy. As we will explore, triple net leases are rarely as clear-cut as they appear at first blush, and investors/landlords need to be aware of pitfalls that can lead to unintentional headaches on their next deal. Landlords invest in properties with certain expectations on how those projects will pencil out, and hidden costs can derail those calculations and change a deal from cash flow positive to negative. Before entering into a triple net lease transaction, an investor must spend the necessary time and resources to fully vet the lease in question and make sure that its terms match the expectations of the business arrangement.

So, what is a triple net lease? If you ask nine different people that question, you are likely to get nine slightly different answers. Generally speaking, a triple net lease is defined as a real property lease where a tenant is responsible for base rent and all other costs, including common area maintenance, taxes, insurance and utilities. The landlord pays no out-of-pocket costs or is otherwise reimbursed for those costs under the agreement. Triple net is a popular legal leasing structure for gross lease deals (where a landlord only leases the land, and not the improvements, to a tenant, who is then fully responsible for the property), as well as in sale–leaseback and build-to-suit transactions.

In addition, triple net leases are common targets for investors in 1031 Tax-Deferred Exchanges. A 1031 (or "like-kind") exchange allows owners to use sale proceeds from one investment property to purchase another investment property of equal or greater value, and then defer payment of capital gains taxes on the original sale. With a triple net lease, those investors are able to park their proceeds in a property without (in theory) having to actively manage that property.

Ultimately, for a landlord/investor, the goal of a triple net deal is to structure the transaction so that the landlord does not pay any out-of-pocket costs or perform any work at the property.

However, there are many different areas where the owner's goal of a hands-off investment can be undermined. Below, we explore two common misconceptions that can cost investors real money and potentially destroy the viability of a deal.

The first area of concern is hidden language in a lease that can directly or indirectly obligate the landlord to take on work or costs. For example, a lease may be marketed as triple net because the tenant performs common area maintenance on the property by plowing snow, maintaining the landscaping and making routine repairs to exterior areas. However, another provision in the lease may directly obligate the landlord to replace the roof or structural components of the building if it becomes necessary or contribute in the event capital repairs are required. These are big ticket items and, should a landlord have to pay out-of-pocket for these costs, it may significantly alter the economics of the investment.

An example of an indirect obligation could stem from a reciprocal easement agreement (also called a declaration or covenants, conditions and restrictions) that encumber the property. Reciprocal easement agreements are put in place when a development is made up of multiple parcels owned by different parties. They are common in retail developments and mixed use projects and can cover everything from use and building restrictions to utility easements. Reciprocal easement agreements often require owners to contribute to the costs to maintain portions of the development that are outside of the boundaries of that particular owner's property. If a triple net lease on that property is not drafted correctly and does not explicitly obligate the tenant to cover the costs under the reciprocal easement agreement, the responsibility to pay those amounts remains with the landlord and will need to come out of the owner's pocket.

The second scenario that owners must be aware of is the difference between performance and reimbursement. A lease may be marketed as triple net because its terms allow a landlord to be reimbursed by the tenant for its common area maintenance, tax and insurance costs — the logic being that, in the end, the landlord is being made whole with respect to all monies that they spend. However, this does not take into consideration the time and money it takes to administer these items before reimbursement — a landlord is going to have to spend time finding contractors, billing them, calculating reconciliations, chasing payments, etc. All of these processes take up significant time and resources for which a landlord is not fully reimbursed.

In the end, the podcasters and YouTubers have somewhat of a point — triple net leases have the potential to be lucrative investments with little to no active responsibilities on the ground. However, any investor in this space must closely scrutinize their lease to ensure there are no hidden landmines tucked away that could jeopardize their deal.

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