

NEGOTIATING COMMERCIAL LEASES

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CALCULATION & RECOVERY OF OPERATING EXPENSES

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III. Calculation & Recovery of Operating Expenses

This outline will take a look at operating expenses and will focus on two primary issues: First, what are they, or, how are they determined? Second, how does a party determine its share of responsibility for operating expenses? The answers to these questions will vary based on the type of lease in question. While multiple lease types and structures will be addressed, this outline will often focus on customary office and retail leases.

A. HOW ARE THEY DETERMINED?

1. The Purpose of the Operating Expense Provisions & Lease Structure

Before exploring the traditional definitions of operating expenses, it is important to understand that the operating expense provision in a lease is a rent escalation provision that is designed to protect the landlord's rental income from increased costs and inflation. Depending on the lease structure, this is accomplished by requiring the tenant to pay all or a portion of the landlord's operating expenses that are specifically applicable to the leased premises, along with a proportionate share of the landlord's operating expenses that are applicable to the entire project or building within which the premises are located.

The scope of a party's responsibility to pay or reimburse operating expenses is primarily controlled by the pass-through structure of the lease. The following is a brief description of the most customary pass-through structures:

a) Net or Triple Net Lease

In a net or triple net lease, the rental income payable under the lease is net of the landlord's operating expenses. Accordingly, in a pure form, the net lease places all risk of ownership, including the risk of increased operating costs on the tenant. There are many issues that should be considered when negotiating a triple net lease that are beyond the scope of this outline. A good example of a net lease is a retail lease, where a tenant is traditionally required to pay base rent plus all actual operating expenses applicable to the demised premises. Office leases and industrial/flex space leases are also sometimes drafted as a net lease.

b) Gross Lease

On the other end of the spectrum is a gross lease, where the rent payable by the tenant is inclusive of all expenses and services provided by the landlord. Of course, this form of lease places the risk of increased operating expenses on the landlord. Primarily for this reason, a true gross lease is rare, but can be useful in unique situations. A gross lease might be used when creating a short term lease, a sublease or a lease to an affiliated party. A gross lease can be very dangerous for a landlord, as the tenant will have little incentive to assist in the control of operating expenses. A variation of the gross lease,

generally referred to as gross plus E, is a modified version of a gross lease form that requires the tenant to pay applicable electricity costs, or electricity costs to the extent that it exceeds a specified amount (or, an expense stop).

c) Modified Gross / Net Lease

In office and industrial leases, it is common to use a hybrid of the gross and net lease, sometimes called a modified gross or modified net lease. These leases will come in two primary variations of the same basic structure.

The first, and most common, is a lease that essentially requires the tenant to pay a proportionate share of future increases in operating expenses during the term of the lease. This is accomplished by designating a base year, which is typically the year prior to the first year of the lease term. The lease will then require that the tenant pay a specified share of all operating expenses, but only to the extent that the annual operating expenses for a subject lease year exceed the annual operating expenses of the designated base year. Traditionally, this lease format will also prohibit the landlord from passing-through charges for expanding the scope of services compared to those provided in the base year. In this type of lease it is critical for the tenant to confirm that the base year operating expenses reasonably represent the standard and expected operating expenses for the building or development in the future. Examples of related issues are discussed in more detail below.

The second variation is similar, but provides less certainty to the tenant. In this form, an expense stop is designated in the lease, such that the tenant pays a designated share of all operating expenses, but only to the extent that the annual operating expenses for a subject lease year exceed the expense stop. This variation of the modified net lease is often used for one of two reasons. First, in a situation where the demised premises is located in a new building, a base year concept will not work (at least not for the first year or two of the lease term) because there is no prior operating year on which base year operating expenses can be based. Second, if it can, the landlord will select an expense stop concept because (i) it allows the landlord to set the expense stop at a threshold lower than actual operating expenses incurred in a prior year, shifting more of the operating expense liability to the tenant, and (ii) it does not traditionally restrict the landlord from adding new services that are reimbursable as operating expense.

In reality, a modified net lease simply takes a designated portion of the tenant's base rent and applies it to the tenant's operating expense liability. As a result, a modified net lease with a base rent of \$26.00/r.s.f with a \$6.00/r.s.f. expense stop is effectively the same lease as a net lease with a base rent of \$20.00/r.s.f. However, there is one key distinction that makes the modified net lease preferable to a landlord. Using the rental rates described above, consider an example where actual operating expenses are \$5.50/r.s.f. In this scenario the tenant of the net lease will pay \$25.50/r.s.f (\$20.00/r.s.f. base rent + actual operating expenses of \$5.50/r.s.f). The tenant of the modified net lease will still pay \$26.00/r.s.f. (\$26.00/r.s.f in base rent + \$0.00/r.s.f for operating expenses, as actual operating expenses did not exceed the expense stop). This occurs because a

modified net lease will not allow the tenant to realize a savings if actual operating expenses fall below the expense stop or base year levels.

As a side note, we have seen some retail developers (generally outside the State of Texas) structure a retail lease in a form that is also a hybrid of a gross lease and net lease, but different than the modified net lease structure discussed above. Essentially the landlords charge the tenant a base rent, a proportionate share of non-controllable operating expenses, and a fixed fee for the balance of the landlord's operating expenses that is subject to a CPI-based adjustment.

2. The Definition of Operating Expenses

In general, operating expenses are comprised of all of a landlord's expenses that are incurred in connection with operating the property demised by the subject lease, generally including the categories of taxes, insurance, maintenance and operation expenses. For the purpose of determining whether or not an operating expense is payable or reimbursable by a tenant, the scope or definition of operating expenses is a matter of contract.

a) The Structure

Most leases will include a definition of the landlord's operating expenses that are reimbursable. Depending on the lease structure, all types of reimbursable operating expenses might be included within a single lease concept or they may be separated into multiple categories. Often, operating expenses will be separated into three categories: insurance expenses, tax costs, and common area maintenance ("CAM") and operation expenses. Categories can be useful for applying a concept (for example, a cap, special audit rights, a unique tenant share calculation, a different base year, or a unique payment schedule) to a portion but not all of the operating expenses.

Consider the example of a retail space lease where the demised premises are located in a shopping center that is comprised of multiple tax parcels. For purposes of some operating expense categories, the tenant's proportionate share may be based upon the entire shopping center, while for ad valorem taxes, tenant's proportionate share may be based solely on the tax parcel that the premises are located within. Because of the potential of significant changes in ad valorem tax assessments, it is also common for landlords to apply a different base year to ad valorem taxes than the base year applied to CAM expenses.

While operating expenses are often divided into multiple categories within a lease, it is customary for one of the categories to be drafted as a catch-all provision. Typically, this catch-all section will include CAM expenses and a definition with language similar to: "...all reasonable and actual costs and expenses incurred by the Landlord in the operation, maintenance or management of the Building/Project, including, but not limited to..." What follows is typically one of the longest and most boring sentences in the lease, being a laundry list of items that are reimbursable operating

expenses. In a fully-negotiated lease (or in a response draft provided by a tenant) this sentence is typically followed by a sentence or paragraph of nearly the same length that provides a list of items that are specifically excluded from operating expenses. The tenant will attempt to begin its itemized list of exclusions with language similar to the following: “Notwithstanding anything to the contrary in the Lease, Operating Expenses shall not include the following....” During the negotiation of the Operating Expense provisions, the landlord is essentially attempting to create a large “in” basket, while the tenant is attempting to create a large “out” basket.

b) The Itemized Description.

Instead of attempting to address the customary operating expense categories within the text of this outline, a chart has been attached as Exhibit A that details some of the more common operating expense categories. For each category, the chart provides an example of a landlord’s and a tenant’s preferred position.

c) New Items.

While the attached chart addresses most of the common operating expenses and specific exclusions, there are a couple of relatively new operating expense items that merit special attention.

(1) The Landlord’s Green Initiatives

It seems logical to think that new green initiatives would have a significant impact on operating expenses. However, identifying a significant financial impact within the context of operating expenses is not a simple endeavor.

Multiple standardized rating systems exist that evaluate the “green” qualities of a building, including U.S. EPA’s Energy Star, the Green Building Initiative’s Green Globes for Continual Improvement of Existing Buildings, and the U.S. Green Building Council’s Leadership in Energy and Environmental Design, sometimes referred to as LEED (each, a “*Green Building Standard*”). Certainly, a building (a “*Green Building*”) certified in accordance with a rating system of a Green Building Standard (especially including a newly constructed Green Building) is more likely to be an efficient building that should in-turn result in lower operating expenses. As a result, a tenant of a true net lease in a Green Building should realize a savings in operating expenses compared to a non-Green Building. However, the tenant’s savings on operating expenses will often be offset such that the tenant’s effective rental rate across building types but within the same class remains relatively constant. This offset occurs because: (i) a higher base rent may be charged for space in a Green Building, and (ii) a Green Building will likely include some operating expenses that are unique to a Green Building, largely attributable to costs associated with Green Building Standards compliance.

An updated lease form or a lease for a Green Building may include specific Green Building costs within the itemized list of operating expenses, such as the following: (i)

costs of maintaining, managing, reporting, commissioning and recommissioning the building with Green Building Standards; and (ii) all costs of applying, reporting and commissioning the building or any part thereof to seek a rating certification pursuant to a Green Building Standard; provided that the cost of such applying, reporting and commissioning of the building or part thereof to seek certification shall be a cost capitalized and amortized under generally accepted accounting principles.¹

In practice, most of the Green Buildings that we see are office buildings, and most office leases are modified net leases that use a base year concept. Since the tenant is only responsible for increases in operating expenses above base year operating expenses and since operating expenses in a Green Building and non-Green Building should rise at similar rates, a tenant's operating expense liability in a Green Building should be substantially similar to a non-Green Building.

We have seen at least one more significant financial issue related to green initiatives that should be a concern for tenants. This issue arises in connection with the conversion of an existing office building into a Green Building. Consider the example of an office building constructed in the 1980s. The landlord desires to convert the building into a Green Building, making it more attractive to future tenants or purchasers. The conversion process is expensive. The landlord begins by hiring a Green Building consultant that performs an evaluation of the building and develops a plan for obtaining the desired certification. The landlord then begins to implement the plan developed by the consultant, including the creation of a new recycling plan, modifying landscaping outside of the building, using green cleaning products and making some expensive modifications to building systems. The landlord passes all of its related expenses on to the tenants of the building as operating expenses. The underlying lease will probably not specifically permit operating expenses related to obtaining certification under Green Building Standards. Therefore, to accomplish this pass-through the landlord will likely rely on a more generic operating expense item that is often found in the definition of operating expenses. This operating expense item is generally described in a manner similar to "...Landlord may include as an Operating Expense the costs of capital improvements to any part of the Building/Project that are reasonably intended to reduce Operating Expenses, amortized or depreciated over the improvement's useful life....." This type of operating expense item is dangerous from a tenant's perspective because it provides the landlord with a basis to charge the tenant for an amortized portion of significant expenses arising in connection with improvements to the building or project that provide no clear and direct benefit to the tenant.

(2) The Margin Tax

Since the date that the margin tax² (the "*Margin Tax*") was first introduced, the market has had a difficult time determining whether or not (or the extent to which) a landlord's Margin Tax liability should be passed-through to tenants as an operating

¹ Steven A. Teitelbaum, *Guide to Writing a Commercial Real Estate Lease, Including Green Lease Language* 12 (Lisa M. Prats & Karen W. Penafiel eds., 2008).

² See Tex. Tax Code Chap. 171.

expense. The debates that ensued were not surprising because reasonable arguments exist on both sides of the issue.

On one hand, landlords can argue that the Margin Tax should be a reimbursable operating expense because it is essentially a rental tax, and rental taxes are traditionally passed-through to tenants as operating expenses in other states. In addition, Landlords will often point to the reduction in ad valorem taxes that was obtained in connection with the creation of the Margin Tax. Because ad valorem taxes are almost always a permitted operating expense, Landlord's will argue that the Margin Tax should be treated as a permitted operating expense. Further, if the parties agreed to a net lease, then the tenant should be obligated to pay a proportionate share of the landlord's margin tax in order to preserve the landlord's rental income.

On the other hand, tenants can characterize the Margin Tax as an income tax. If the Margin Tax is essentially an income tax, then a landlord's Margin Tax obligations should not be passed-through to the Tenant as an operating expense, just as federal income taxes are generally excluded from reimbursable operating expenses. In support of this argument, a tenant can point to entity-based exceptions to the Margin Tax that are consistent with other types of income taxes.

In practice, the Margin Tax appears to have had the most significant impact on leases that pre-date the introduction of the Margin Tax. With respect to these leases, landlords and tenants are forced to apply operating expense definitions to the Margin Tax that are not directly applicable. With respect to leases signed after the enactment of the Margin Tax, the issue has become another business point open for negotiation. Tenants of significant leases have had success in excluding the landlord's Margin Tax liability from operating expenses, while tenants of less significant leases are generally required to pay a proportionate share of the landlord's Margin Tax liability as an operating expense. In many instances the parties are able to negotiate compromises and creative resolutions. For example, the parties might agree to include the following within the definition of operating expenses: "Margin Taxes calculated as if Landlord's gross receipts from this Lease were the only gross receipts of Landlord subject to the Margin Tax, and the deductions component of Margin Taxes for the purposes of this Lease will be calculated by taking Tenant's proportionate share of Landlord's total deductions attributable to the Building/Project." While this could potentially be a fair solution, a practical problem remains. The accounting required by the landlord to accommodate this concept is burdensome. It will also be difficult for the tenant to confirm the landlord's compliance with the limited pass-through of its Margin Taxes unless the tenant obtains and enforces audit rights with respect to the landlord's calculation of operating expenses (discussed below).

With respect to modified net leases that use a base year, the tenant would only be responsible for a proportionate share of the landlord's increase in Margin Tax liability, if any (assuming a base year of 2008 or later). Accordingly, in most new office leases the Margin Tax presents little concern for the tenant. However, a tenant should be concerned if it enters into a new lease with a landlord that is a REIT. To highlight the concern,

consider the example of a modified net lease with a base year of 2008 that allows the landlord to pass-through Margin Tax liability as an operating expense. The landlord is a REIT and is therefore not obligated to pay the Margin Tax. Two years later the landlord sells the building to a new landlord that is a limited liability company. The new landlord is obligated to pay the Margin Tax. As a result, for every year after the assignment of the landlord's interest in the lease, the tenant will be obligated to pay a proportionate share of the new landlord's Margin Tax liability. Accordingly, a lease with an entity that is exempt from the Margin Tax may present the most significant Margin Tax-related exposure for the tenant.

3. What if the lease is silent?

When negotiating an operating expense provision in a commercial lease, the parties should start from the position that the landlord may not pass-through a charge to the tenant as an operating expense unless the lease states that it may pass-through such charge to the tenant. Although exceptions exist,³ this position is supported by the Texas Property Code, as it states that “[a] landlord may not assess a charge, excluding a charge for rent or physical damage to the leased premises, to a tenant unless the amount of the charge or the method by which the charge is to be computed is stated in the lease, an exhibit or attachment that is part of the lease, or an amendment to the lease.”⁴ This position is also supported by *Wilbur and Village Lane Limited v. Cinemark Corporation*.⁵ In *Wilbur*, the appellate court confirmed a judgment that a tenant was not obligated to pay a management fee to the landlord because the management fee was not a common facility expense, as defined in the lease.⁶ The lease defined common facility expenses as “[a]ll liability insurance costs; all costs to maintain, repair, replace, supervise and administer common areas, parking lots, sidewalks, driveways and other areas used in common by the tenants or occupants of the entire shopping center, which costs may include fees paid to a third party in connection with same....”⁷ Similarly, in *A.J. Robbins & Co. v. W.C.*

³ See 5-90 *Texas Real Estate Guide* (MB) § 90.26(6) (stating that “Despite this general prohibition [set forth in Tex. Prop. Code § 93.012], a landlord may nevertheless assess a charge to a tenant if the charge is permitted by the lease but the method for computation of the amount is not stated in the lease if the method by which the charge is computed is both reasonable and customarily used by landlords in commercial leases of a similar duration and for a similar type of commercial property as the lease signed or entered into by the landlord and tenant.”); Further, it is important to note that most leases will attempt to categorize operating expenses as additional “rent” in an effort to qualify the tenant’s operating expense liability as an exception to Section 93.012 of the Texas Property Code.

⁴ This section does not affect a landlord’s right to assess a charge or obtain a remedy allowed under statute or common law. Tex. Prop. Code § 93.012.

⁵ *Wilbur & Vill. Lane Ltd. v. Cinemark Corp.*, 2002 Tex. App. LEXIS 3716 (Tex. App.—Houston [14th Dist.] 2002, no pet.) (not designated for publication) (affirming judgment that tenant was justified in refusing to pay management fee because management fees were not a “common facility expense,” which the lease defined as “[a]ll liability insurance costs; all costs to maintain, repair, replace, supervise and administer common areas, parking lots, sidewalks, driveways and other areas used in common by the tenants or occupants of the entire shopping center, which costs may include fees paid to a third party in connection with same....”).

⁶ *Id.*

⁷ *Id.*

Roberts, the court held that absent a contractual obligation, a lessee has no responsibility for ad valorem taxes on privately owned leased realty.⁸

However, every operating expense item does not necessarily have to be identified in the lease, as long as the expense item is included within a category of expenses that is identified as an operating expense.⁹ In *Group Hospital Services*, the court held that disputed charges not expressly delineated in a lease were not impliedly excluded under the doctrine of *expression unius est exclusion alterius* from the operating costs provision of the lease, where lease terms were couched in broad categories and disputed charges could be subsets of broad categories.¹⁰

The holdings in *Wilbur* and *Group Hospital Services* appear to be in conflict. A reasonable argument can be made based on the holding in *Group Hospital Services* that the management fee charged by the landlord in *Wilbur* could be a subset of the broad categories of operating expenses permitted by the lease in *Wilbur* (i.e. a cost to “supervise and administer”) and therefore should have been a permitted operating expense. However, if the holdings of *Wilbur* and *Group Hospital Services* are to be interpreted as consistent holdings, then the lesson to landlords and tenants seems to be that operating expenses may be described in categories of expenses, but the categories should be described in sufficient detail to avoid any ambiguity as to the scope of operating expense items included within the subject category.¹¹

While a tenant may be able to successfully challenge an operating expense charged by a landlord, it is not likely that that a tenant will be able to bring a class action claim against the landlord for the subject practice. In *Academy Corporation v. Moore*, a shopping center tenant that prevailed on a claim that its tax escalation was unenforceable was not allowed to act on behalf of a class of similarly situated tenants because the landlord had treated other tenants differently.¹²

4. What is each party’s respective share?

The most common method used to define a tenant’s proportionate share of operating expenses is to apply a fraction, the numerator of which is the rentable square footage located in the leased premises and the denominator of which is the rentable square footage located in the entire building or project. This standard fraction is

⁸ *A.J. Robbins & Co. v. W.C. Roberts*, 610 S.W.2d 854, 856 (Tex. App.—Amarillo 1980, writ ref’d) (noting that a lessee in possession of privately owned realty has no obligation for ad valorem taxes merely because of his possession).

⁹ *Group Hospital Servs., Inc. v. One & Two Brookriver Ctr.*, 704 S.W.2d 886, 890 (Tex. App.—Dallas 1986, no writ).

¹⁰ *Id.*

¹¹ The question of whether a lease is ambiguous is one of law for the court. When an instrument remains reasonably susceptible to more than one meaning after the correct rules of interpretation have been applied, extraneous evidence is then admissible to determine the instrument’s true meaning. *Tierney v. Lane, Gorman, Trubitt & Co.*, 664 S.W.2d 840, 841 (Tex. App.—Corpus Christi 1984, no writ) (citing *R & P Enterprises v. LaGuarta, Gavrel & Kirk*, 596 S.W.2d 517 (Tex. 1980)).

¹² *Academy Corp. v. Moore*, 1990 Tex. App. LEXIS 2516 *6 (Tex. App.—Houston [14th Dist.] 1990, writ dism’d w.o.j.) (not designated for publication).

appropriate for many categories of operating expenses, but is not sufficient for all categories.

In some cases, the cost of a specific service provided to the leased premises is easy to identify, such as electricity provided by a separate meter. In this case, the tenant should be responsible for the actual costs of electricity provided to the premises, along with a proportionate share of electricity provided to common areas. Electricity provided to other occupants of the building or project should be excluded from the definition of operating expenses.

In some cases, an operating expense item will benefit the leased premises and additional property, but less than all of the building or project. For these costs, the applicable tenant's share definition should be adjusted with a denominator that tracks the scope of the property benefited by the applicable operating expense item. This structure is common in multi-phase developments and office parks comprised of multiple office buildings.

Sometimes a proportionate share based on rentable square footage, even when the numerator and denominator are appropriately tailored, creates a result that is not equitable. This issue is best highlighted by an example related to utility expenses. Consider two tenants, each occupying one-half of a warehouse pursuant to a net lease. Each utility service serving the warehouse is provided through a single meter. One tenant uses its premises for dry storage. The other tenant uses its premises for cold storage, requiring excessive amounts of electricity and water. If the tenants each reimburse the landlord for a proportionate share of utilities based upon rentable square footage, the dry storage tenant will be required to subsidize the cold storage tenant's utility use. To address this concern, a lease will often provide that a landlord may in its reasonable discretion adjust an operating expense category such as electricity costs to address excessive consumption. This same issue is encountered in mixed-use developments which are discussed below in this outline. A tenant facing this issue will likely desire more comfort than a landlord's discretion as to when and to what degree a tenant's share of operating expenses should be adjusted. In the case of a significant concern with utility usage, a tenant could require that a separate meter be installed for the utility of concern. That option can be prohibitive due to cost, in which case the tenant may seek additional comfort regarding the method by which the landlord will adjust operating expenses to address excessive usage.

As another example, consider a tenant of an outlot in a new retail shopping center development. This type of lease is often signed before any buildings are constructed within the development and owners/occupants of other portions of the shopping center may not be required to build improvements on their property. If operating expenses in the development are based on rentable square feet located in a building, then an outlot that includes 5% of the acreage within a development could be obligated, at least initially, to pay 20% or more of the operating expenses or CAM charges for the entire development. This type of issue is usually addressed within a set of CCRs governing the development, with a lease passing-through CCRs assessments to the tenant. An appropriate share

calculation in this situation is often based on acreage (either the acreage of the entire outlot and development or the acreage within the permitted buildable area within such parcels), rather than rentable square feet.

With the foregoing examples in mind, a real estate professional advising a tenant must investigate not only the proposed use of his client, but also the other uses permitted within the development in order to evaluate whether or not the share of operating expenses attributed to his client is appropriate.

5. Selected Issues Related to Lease Structure

a) Base Year with new construction

Some of the most common problems encountered with respect to the pass-through of operating expenses arise in connection with a modified net lease for a newly constructed building or development where the base year is set as the initial year of occupancy for the building or development. The initial occupancy year of a building or project serves as a poor base year because its operating expenses have not yet settled. There may be minimal maintenance expenses during this year because all building systems are newly installed. Ad valorem taxes are assessed based on improvements existing as of January 1. If a building or project is completed late in the year, ad valorem taxes for the following year can be expected to rise dramatically with the increased assessed value of the building or project. In either of these examples, operating expenses may rise dramatically after the first year of occupancy.

To address this issue the parties may agree to set the base year as the second full year of the lease term. As a result, the lease will essentially be a gross lease for the first two years of the lease term. In the alternative, the parties can create a modified net lease that begins by using an expense stop for the first year or two of the lease term, and then transitions to a base year in the second or third year of the lease term.

b) Base Year & Tax Incentives

Abnormalities in operating expenses can occur outside of the first year that a building or project is occupied. Consider the example of a new office lease with a modified net pass-through structure. The office building has been open and operating for three years prior to the date of the lease. The base year is set at year X. Prior to year X, landlord obtained significant tax incentives that expire on year X+4. As a result, ad valorem taxes will increase significantly in year X+4, as will the tenant's proportionate share of ad valorem taxes. This example highlights the importance of investigating whether or not a proposed base year is a fair representation of a normal operating year for the building or project.

c) Mixed Use.

The developer of a mixed use project must devote more thought into the method by which it passes operating expenses through to occupants. As briefly discussed in this outline, different pass-through structures and customs exist with respect to office and retail uses. More distinctive differences exist between those uses and residential use. These different uses consume operating expense services at different rates. This issue is further complicated by the fact that mixed use developments are generally more expensive to operate than a comparable single-use development. As a result, a simple proportionate allocation of operating expenses based upon square footage will likely cause a significant problem for at least one, if not all of, the different types of occupants.

One common approach to recovering operating expenses in a mixed use development is to (i) first, divide the operating expenses into categories, and (ii) second, apply weighted shares to each type of use based upon estimated (or actual if possible) consumption of the service provided by the subject expense category. The problems exist in applying the varied weights to the shares of the different use types. For example, how should costs associated with events unique to mixed use developments be apportioned among users? If a mixed use development coordinates a weekly event that shows movies in the development's park, what types of occupants should bear the burden of the related costs and to what degree when compared with other types of occupants? At least one prominent mixed use developer has elected to allocate users' respective operating expense shares based on parking spaces. In theory, the amount of parking required by a user should provide a reasonable estimate of how intensive that user's operation will be within the development. This theory may not make sense for all types of operating expenses, but it does seem to be a good starting point.

With the foregoing in mind, it is important to note that, unless a lease states otherwise, a landlord is not prohibited from converting portions of an existing building to a different use.¹³ Accordingly, it is important that a tenant confirm within the lease (or by other enforceable restriction benefiting the tenant), that either (i) the landlord is not permitted to convert the use of a portion of the subject building or project without the tenant's consent, or (ii) if the landlord does convert the use of a portion of the subject building or project, the tenant's anticipated operating expense liability based on a single use of the building or project will be preserved. If these protections are not obtained, a tenant could find itself subsidizing another occupant's operations at the building or project.

B. HOW TO FIGURE THEM INTO YOUR LEASE

1. Estimates

Often a landlord will provide a tenant with an estimate of the tenant's responsibility for operating expenses. In fact, leases will often require that the landlord

¹³ See *Cantile v. Vanity Fair Props.*, 505 S.W.2d 654 (Tex. Civ. App.—San Antonio 1973, writ ref'd n.r.e.) (holding that a retail lease does not contain an implied covenant prohibiting the landlord from converting other space in the building leased by a tenant to office use).

provide the tenant with an annual estimate or budget for operating expenses. From the tenant's perspective, these estimates are nice to have, but are not reliable because (unless the lease states otherwise), the tenant will not have a remedy if the estimate or budget is much lower than the tenant's actual operating expense liability. Further, unless a lease specifically states otherwise, a landlord's failure to provide an estimate or budget for operating expenses in accordance with the terms of a lease does not excuse the tenant from its obligations to reimburse the operating expenses to the landlord in accordance with the terms of the lease.¹⁴

2. Negotiating a Cap

From a tenant's perspective, much comfort can be gained by negotiating a cap on its responsibility to pay for or reimburse operating expenses. However, without careful drafting, a cap may provide a false sense of comfort to the tenant. From a landlord's perspective, any cap on a tenant's operating expense obligations places the landlord's rental income in jeopardy.

a) Type of Cap

If a cap on operating expenses is obtained at all, it is almost always crafted as a cap on the permitted annual increase on the tenant's responsibility for operating expenses, or a specified category of operating expenses.

b) Limited to Controllable Expenses

Almost every cap on operating expenses reimbursable by a tenant will be limited to apply only to operating expenses that are reasonably controllable by the landlord. This means that the lease must subdivide operating expenses into two categories, those that are controllable and those that are not. This distinction can be accomplished with a simple definition of controllable operating expenses, typically defined similar to: "all Operating Expenses other than real estate taxes, the cost of all insurance relating to the Building/Project, and the cost of all utilities that are included as an Operating Expense."

c) Cumulative vs. Non-Cumulative

Whether a periodic cap on increases in operating expenses payable by a tenant is cumulative or non-cumulative is a key distinction to both the landlord and tenant.

From a tenant's perspective, the value of a cap becomes diluted if it is drafted as a cumulative cap. Imagine your tenant-client calls you, upset that operating expenses in the lease you drafted for her rose 7% in one year. The client wants to enforce the 5% cap on annual increases in operating expenses that was obtained during tough negotiations. Now imagine how upset your client will be when you explain that the 7% increase is permitted because the cap is cumulative. Operating expenses rose by 4% each of the prior two

¹⁴ *Group Hospital Servs., Inc.* at 890 (noting that courts prefer to construe a contract provision as a covenant rather than a condition).

years. As a result, the landlord saved the 1% gap between the actual increase and the cap during each of the prior two years for future years. “A bit like roll-over minutes on your cell phone” you explain.

While a cumulative cap may seem unfair to the tenant, a non-cumulative cap may seem unfair to the landlord. A good landlord that aggressively maintains operating expenses year-after-year with only minor increases will likely be upset when, in a year of soaring prices, the tenant enforces a non-cumulative cap on operating expenses leaving the landlord to pay the balance out of its rental income. With this scenario in mind, landlords are slow to allow non-cumulative caps on annual increases in operating expenses.

3. Audit Rights

a) The Purpose of Audit Rights & Reconciliation Statements

For some landlords, operating expenses can be a profit center. To address this concern, a lease should contain a section stating that a landlord may not recover more than 100% of its actual operating expenses. However, from a tenant’s perspective it is difficult to know how a landlord is abusing the operating expense provisions of a lease without auditing the landlord’s records. Often a tenant will receive a bill for its share of operating expenses that does not provide any explanation of the specific expenses that comprise the total billed amount, nor are any supporting documents provided to the tenant (such as copies of invoices paid by the landlord). This gap in disclosure can be addressed partially by a lease provision that requires the landlord to provide a detailed annual reconciliation statement for operating expenses billed to the tenant. However, this information allows a tenant to identify only the most obvious errors. The tenant will therefore request the right to hire a third-party consultant to audit the landlord’s books and records related to operating expenses. In connection with this request, the tenant should also require: (i) that the landlord’s books and records be made available in the city where the demised premises are located; and (ii) that the landlord reimburse the tenant for the cost of the audit if the audit reveals that the tenant has been overcharged by a certain percentage of the total expenses.

b) Limitations

If a lease provides a tenant with operating expense audit rights, the landlord will likely require a set of limitations. First, the landlord will attempt to prohibit contingency fee audits. It is rare for a landlord to allow contingency fee audits. Second, the number of audits permitted will be limited to a maximum number per specified time period. Typically, no more than one audit is permitted every lease year. This limitation is usually acceptable to a tenant. In addition, the landlord will require that the tenant elect to exercise its audit right within a specific period of time (based on the end of the operating expense year or the date that an operating expense reconciliation statement is issued), such that the tenant will lose its audit rights for a subject expense year if tenant does not timely exercise its rights. This can be a dangerous limitation. A tenant might request that

the landlord provide a notice to the tenant regarding the pending lapse of its audit rights before they are lost entirely. However, a landlord will be hesitant to accept this administrative burden.

c) Internal Review Departments & Consultants

In the present economic conditions, it will be interesting to see if tenants become more vigilant in reviewing the operating expenses charged by a landlord. We have noticed that some larger clients with significant operating expense liabilities have recently created internal departments dedicated solely to the management of operating expenses. Third party consultants are available to provide similar services to clients with smaller operations and are now actively marketing their services.

4. The Market

Without a cap or other reliable control on the pass-through of operating expenses, a tenant is often forced to rely on the market to protect it from significant increases in operating expenses. Especially with respect to first-class operations, the landlord and its management company will want to maintain a good reputation for efficiently managing a building so that it can attract the next tenant.

5. Gross up

Grossing-up is a method by which phantom expenses are included within operating expenses and passed-through to the tenant. This sounds terrible from a tenant's perspective. However, when a gross-up clause is properly drafted it should benefit both the tenant and the landlord, as it should cure unintended distortions in a party's operating expense liability that occur when a building is less than fully-occupied. A simple gross-up provision in an office lease may look something like the following:

The Operating Expenses that vary with occupancy and that are attributable to any part of the lease term in which less than 95% of the rentable area of the Building/Project is occupied by tenants will be adjusted by the Landlord to the amount that Landlord reasonably believed they would have been if 95% of the rentable area of the Building/Project had been occupied.

The gross-up provision is intended to address only those operating expenses that vary with the occupancy of the building or project, such as utilities or janitorial services for areas that are available for occupancy but are not occupied by other tenants.

In an extreme example, consider a tenant that occupies 25% of the rentable area within a building and the remainder of the building is not occupied. The landlord incurs \$3,000.00 in janitorial and maintenance expenses for a billing period. To keep the numbers simple, \$1,000.00 of the expenses are directly attributable to the tenant's premises, while the remaining \$2,000.00 are attributable to common areas of the building. Without a gross-up provision the tenant would be obligated to reimburse the

landlord \$750.00 of the total expenses (= the tenant's proportionate share of 25% multiplied by \$3,000.00). Obviously, the tenant has received a windfall because it has not covered the expenses applicable to its premises, much less a portion of the expenses applicable to the common areas.

Now, consider the same example with a simple gross-up provision applied. First, calculate the tenant's responsibility for the \$2,000.00 in expenses attributable to the common area. Because these expenses do not vary with occupancy, they are not subject to the gross-up provisions. Therefore, tenant's responsibility for this portion of the expenses is \$500.00 (= the tenant's proportionate share of 25% multiplied by \$2,000.00). Next, calculate tenant's responsibility for the \$1,000.00 in expenses attributable to the leased premises. These expenses are subject to the gross-up provision because maintenance and janitorial services for tenant-occupied portions of the building would be larger if the building were 95% occupied. As a result, the operating expense for providing maintenance and janitorial services to tenant-occupied premises is grossed-up to \$3,800.00 (= 1,000.00 of base expenses multiplied by 95% and then divided by 25%). Tenant's proportionate responsibility for this grossed-up charge is \$950.00 (= tenant's proportionate share of 25% multiplied by the grossed-up expense of \$3,800.00). Accordingly, tenant's total responsibility for the \$3,000.00 of maintenance and janitorial expenses incurred by the landlord is \$1,450.00. This result is fair. The tenant paid nearly all of the expenses directly attributable to its premises, along with a proportionate share of expenses attributable to common areas.

Even with the simple example described above, the calculation of operating expenses with an active gross-up provision can be complicated. As a result, it will be difficult for a tenant to identify errors in a landlord's calculation of grossed-up operating expenses without obtaining and enforcing audit rights. It is also noteworthy that a simple gross-up provision, such as the example provided in this outline requires that the landlord use its judgment in identifying the operating expenses that vary with occupancy. For many operating expense categories, such as the example provided above, the decision is simple. However, the decision is not simple for other charges. A prime example is a landlord's management fee. Depending on the basis for the landlord's management fee, it could be characterized as a variable or static expense. A concerned tenant with the leverage to negotiate the gross-up provision should consider applying a reliable definition of variable expenses that are subject to gross-up.

A gross-up provision can also be beneficial to a tenant. A tenant of a modified net lease that uses a base year should require that base year expenses be grossed-up. This is especially true if the lease has a gross-up provision that applies post base year. Consider the example of a lease with base year operating expenses of \$6.00/r.s.f., where the building is not fully-occupied. During the second year of the lease term the building remains less than fully-occupied and the landlord applies the gross-up provision to operating costs, such that operating costs are \$8.00/r.s.f. Although landlord's actual operating costs did not increase at all (in fact they may have decreased) when compared to the base year, the tenant is obligated to pay \$2.00/r.s.f in operating expenses.

A tenant can encounter this same problem even if the lease does not include a gross-up provision. Consider the same example, a tenant of a modified net lease with base year expenses of \$6.00/r.s.f., where the building is not fully-occupied. The lease does not include a gross-up provision. However, during the second year of the tenant's lease term, the landlord leases a significant amount of space in the building that was previously unoccupied. As a result, operating costs increase to \$8.00/r.s.f., such that the tenant is responsible for \$2.00/r.s.f. in operating expenses, although the rates for the individual operating expenses did not increase. This could be a surprising result to a tenant-client if the issue was not properly identified by the real estate professional during the negotiation of the lease.

While the gross-up provision is traditionally used in office leases and in industrial leases, some retail developers have attempted to apply a similar concept to retail leases. This will be an interesting trend to watch when the retail market returns.

C. A LOOK AT THE EXHIBITS

1. Exhibit A – An Operating Expense Negotiation Table
2. Exhibit B – A Resource List

Negotiating Commercial Leases (Dallas – May 27, 2009)
Calculation & Recovery of Operating Expenses

EXHIBIT A

AN OPERATING EXPENSE NEGOTIATION TABLE

A. SELECTED EXPENSE ITEMS CUSTOMARILY INCLUDED AS AN OPERATING EXPENSE		
Category	Example Description in a Landlord Form	Tenant Response
Services	The cost of all maintenance and service agreements for the Project and the equipment therein, including but not limited to alarm service, security service, access control, landscaping, window cleaning, pest control, elevator maintenance and janitorial service.	The tenant will want to (i) exclude repairs and general maintenance paid by proceeds of insurance, by Tenant or by other third parties, (ii) exclude alterations attributable solely to specific tenants of the Building, and (iii) place limits on rental fees.
Utilities (Common Area)	The cost of all utility services used in connection with the operation and maintenance of the Common Areas.	Acceptable, subject to tenant's requested list of specific exclusions.
Supplies	The cost of all supplies, tools, equipment and materials used in the operation and maintenance of the Project.	The tenant will want to prorate costs for supplies that are used at multiple projects owned or operated by the landlord. This expense item should also be subject to the tenant's requested exclusions related to capital expenses and rental fees (described below).
Common Area Maintenance	The cost of keeping the Common Areas in a safe, neat and clean condition.	The tenant may attempt to tie the scope of permitted maintenance expenses to the landlord's maintenance standard described in the lease.
Common Area Maintenance	The cost of sweeping, patching, striping and sealing all sidewalks, parking areas and roadways in the Common Areas.	Acceptable, subject to tenant's requested list of specific exclusions.
Common Area Maintenance	The cost of maintaining and repairing all directional signs, pavement signs and other traffic control devices in the Common Areas.	Acceptable, subject to tenant's requested list of specific exclusions.
Common Area Maintenance	The cost of repairing and replacing all lighting fixtures in the Common Areas, including, without limitation, all bulbs and ballasts therefor.	Acceptable, subject to tenant's requested list of specific exclusions.
Common	The cost of repairing and maintaining all freestanding signs and	The tenant may object to the maintenance of multi-tenant signs

Negotiating Commercial Leases (Dallas – May 27, 2009)
Calculation & Recovery of Operating Expenses

Area Maintenance	other common signs in the Common Areas.	that do not include the tenant's signage.
Common Area Maintenance	The cost of caring for and maintaining all landscaped and planted areas in the Common Areas.	Acceptable, subject to tenant's requested list of specific exclusions.
Insurance	The cost of all insurance relating to the Project, including, but not limited to, the cost of property insurance, casualty, rental loss and liability insurance applicable to the Project and Landlord's personal property used in connection therewith, and the cost of deductibles paid on claims made by Landlord.	The tenant may request that (i) the operating expense item be limited to apply only to insurance that the landlord is required to maintain pursuant to the lease, and (ii) deductible amounts be limited to the extent not in excess of deductible amounts maintained by owners of comparable buildings in the subject market.
Property Taxes	<p>All taxes, assessments and governmental charges, whether or not directly paid by Landlord, whether federal, state, county or municipal and whether they are imposed by taxing districts or authorities currently taxing the Project or by others subsequently created or otherwise, and any other taxes and assessments, assessed against or attributable to the Project or its operation, together with the reasonable cost (including attorneys, consultants and appraisers) of any negotiation, contest or appeal pursued by Landlord in an effort to reduce any such tax, assessment or charge, and all of Landlord's reasonable administrative costs in relation to the foregoing ("<i>Real Estate Taxes</i>"); provided, however, that if at any time during the lease term the present method of taxation or assessment shall be so changed that the whole or any part of the taxes, assessments, levies, impositions or charges now levied, assessed or imposed on real estate and the improvements thereof shall be changed and as a substitute therefore, or in lieu thereof, or in addition thereto, taxes, assessments, levies, impositions or charges shall be levied, assessed or imposed wholly or partially as a capital levy or otherwise on the rents received from the Project or the rents reserved herein or any part thereof, then such substitute or additional taxes, assessments, levies, impositions or charges, to the extent so levied, assessed or imposed, shall be deemed to be included within Real Estate Taxes.</p> <p>TENANT HEREBY WAIVES ALL RIGHTS TO PROTEST THE APPRAISED VALUE OF THE PROPERTY OR</p>	The tenant may request that: (i) the term "Real Estate Taxes" specifically exclude: federal and state taxes on income, death taxes, franchise taxes, gift, inheritance, and estate taxes, the Margin Tax and any taxes imposed or measured on or by the income of Landlord from the operation of the Project unless such tax is in lieu of ad valorem taxes on the Project itself; (ii) new types of taxes and assessments included within the definition of Real Estate Taxes be limited to the extent that such tax would be payable if the Project or the revenues therefrom were the only property of the Landlord subject to such tax, and (iii) Landlord covenant to use commercially reasonable efforts to contest where appropriate appraised values of the Project in order to minimize ad valorem taxes.

Negotiating Commercial Leases (Dallas – May 27, 2009)
Calculation & Recovery of Operating Expenses

	APPEAL THE SAME AND ALL RIGHTS TO RECEIVE NOTICES OF REAPPRAISALS SET FORTH IN SECTIONS 41.413 AND 42.015 OF THE TEXAS TAX CODE.	
Employee Labor Costs	Labor costs, including, wages, salaries, social security and employment taxes, medical and other types of insurance, uniforms, training, and retirement and pension plans.	The tenant will request that these expenses be pro-rated to reflect the extent of the employee's time associated with the non-leasing matters at the Building and/or the Property.
Management-Related Expenses	Landlord's and/or Landlord's managing agent's reasonable accounting and audit costs and reasonable attorneys' fees applicable to the management of the Project in the ordinary course of business.	The tenant may request that this expense item specifically exclude any costs associated with an audit of the landlord's or its managing agent's records that is performed at the request of or on behalf of a third party, including any tenant or occupant of the Project.
Management/Administrative Fee	All property management fees for the Project which shall not annually exceed ___ percent (___%) of the gross revenue from the Building/Project.	The tenant may request that (i) the management fee be applied to base rent under the lease, rather than revenue from the building or project, and (ii) this expense item be specifically excluded from the gross-up provision.

B. SELECTED EXPENSE ITEMS CUSTOMARILY EXCLUDED FROM OPERATING EXPENSES		
<u>Category</u>	<u>Example Description in Tenant Form</u>	<u>Landlord Response</u>
Financing & Master Lease Expenses	Any interest or payments on any mortgages or deeds of trust or rental on any ground or underlying lease, and penalties and charges incurred as a result of Landlord's late payment under such mortgages, deeds of trust or ground leases.	This type of exclusion is often accepted by landlords.
Leasing & Marketing Expenses	Legal fees, leasing commissions, costs of art and sculptures, advertising, and marketing expenses and other such costs incurred in connection with the development, marketing, advertising, or leasing of the building or project, including but not limited to expenses associated with maintaining a leasing office.	Landlord may (i) seek a marketing fund contribution from a tenant of a retail lease, and (ii) seek a limit on the exception for expenses associated with maintaining a leasing office to the extent that the office area is also used for property management activities.

Negotiating Commercial Leases (Dallas – May 27, 2009)
Calculation & Recovery of Operating Expenses

Leasing & Marketing Expenses	Market Concessions granted to specific tenants. “Market Concessions” means any allowances or credits provided to any tenant for rent, construction or renovation (including design and permitting) of tenant improvements, moving or similar purposes, and the costs of any construction or renovation (including design and permitting) of tenant improvements performed by Landlord for any tenant.	This type of exclusion is often accepted by landlords.
Leasing & Marketing Expenses	Legal costs in connection with lease negotiations or the enforcement of leases.	Although not an operating expense, the landlord may desire to specifically reserve its lease rights with respect to legal costs related to the subject lease.
Prepayment of Expenses or Reserves	Reserves for bad debts, future repairs, improvements, additions or any expenditures that would be incurred subsequent to the current calendar year.	This type of exclusion is often accepted by landlords.
Expenses Not Benefiting Tenant (Work for Other Tenants)	Costs or expenses of providing or performing improvements, work, renovations, decorating, painting, or repairs to or within any portion of the premises of any other tenants or occupants of the Building or Project or to any building or structure which is not part of the Common Area.	This type of exclusion is often accepted by landlords.
Expenses Not Benefiting Tenant (Services for Other Tenants)	Expenses in connection with services or other benefits of a type which Tenant is not entitled to receive under the Lease but which are provided to another tenant or occupant or which are provided to one or more, but not all, tenants of the Property.	This type of exclusion is often accepted by landlords.
Expenses Not Benefiting Tenant (Disputes)	Costs or expenses incurred as a result of disputes or negotiations with other tenants or occupants of the Property, including but not limited to attorneys’ fees, any costs or expenses incurred in negotiating, amending, administering or terminating leases, any brokerage commissions, or construction or planning expenses.	This type of exclusion is often accepted by landlords.
Expenses Not Benefiting Tenant	Costs of electricity or other utilities used by any tenant (other than Tenant) of the Building or Project in excess of standard use amounts.	The landlord will likely seek to control the method by which excess utility usage is determined, such as adding “as determined by landlord in its reasonable discretion” to the end of the

Negotiating Commercial Leases (Dallas – May 27, 2009)
Calculation & Recovery of Operating Expenses

(Utilities)		proposed exclusion.
Expenses Not Benefiting Tenant (Utilities)	Utility and air conditioning or heating costs or other expenses which are separately billed to specific tenants.	The landlord will likely accept this exclusion, but will require that the applicable tenant share for the subject utility be adjusted accordingly.
Expenses Otherwise Reimbursed to Landlord	Costs or expenses incurred that are subject to reimbursement by tenants (including, without limitation, Tenant) or third parties (including, without limitation, insurers), including but not limited to Landlord's cost of electricity and other services sold separately to tenants for which Landlord is entitled to be reimbursed by such tenants as an additional charge over and above the base rent and operating expenses or other rental adjustments payable under the lease with such tenant as well as domestic water sub-metered and separately billed to tenants.	This type of exclusion is often accepted by landlords.
Covered Repairs	Any expense for repairs or maintenance which was covered by warranties and service contracts in existence on the Commencement Date.	The landlord will require that this exclusion be limited to the extent that landlord was actually reimbursed for the excluded expenses.
Covered Repairs	Repairs occasioned by fire, windstorm, other casualty or condemnation and paid for through insurance or condemnation proceeds.	The landlord will require that this exclusion include an exception for any applicable deductibles.
Landlord Failure Expenses (Violation of Laws, Rules...)	Penalties, fines, late fees, interest or similar charges incurred due to violations by Landlord or any tenant (other than Tenant) of the Project of any laws, rules, regulations, or ordinances applicable to the Project.	The landlord's primary concern will be that this exclusion does not apply to (and tenant will be responsible for the entire amount of, as opposed to a proportionate share of) penalties, fines, late fees...that result from violations of the tenant.
Landlord Failure Expenses (Late Payments)	Fines, interest and penalties incurred due to the late payment of Taxes.	The landlord's primary concern will be that this exclusion does not apply to (and tenant will be responsible for the entire amount of, as opposed to a proportionate share) fines, interest and penalties that result from tenant's failure to pay Taxes, or its proportionate share thereof.
Landlord	Costs or expenses for correcting defects in the design or	

Negotiating Commercial Leases (Dallas – May 27, 2009)
Calculation & Recovery of Operating Expenses

Failure Expenses (Building Defects)	construction of the Building or Project, including without limitation, latent defects in the Building or Project.	
Business Expenses (Overpayments to Related Companies)	Overhead and profit paid to subsidiaries or affiliates of Landlord for services on or to the Project and/or Premises, to the extent only that the costs of such services exceed competitive costs for such services were they not rendered by a subsidiary or affiliate.	This type of exclusion is often accepted by landlords.
Business Expenses (General Overhead)	Landlord's general corporate overhead costs and general administrative expenses organizational fees, and partnership expenses.	The landlord will require that this exclusion include an exception for the portion of such costs allocable to the building or project.
Business Expenses (Personnel Salaries)	Salaries of personnel of Landlord above the level of building manager.	This type of exclusion is often accepted by landlords.
Environmental	The cost of any environmental remediation of the Project or the Building, including without limitation any costs incurred to test, survey, cleanup, contain, abate, remove, or otherwise remedy hazardous wastes or asbestos-containing materials from the Project.	The landlord will require that this exclusion include an exception to the extent directly caused or released by the tenant, its agents, employees or invitees.
Transaction Expenses Related to Sale of Property	Costs incurred in connection with the sale, financing or refinancing of the Building or Project.	This type of exclusion is often accepted by landlords.
Depreciation	Depreciation and amortization, including but not limited to depreciation of structures or buildings located in the Project, including the Building.	The landlord will likely require an exception for (i) amortization of capital costs to the extent included within Operating Expenses, and (ii) materials, tools, supplies, and vendor-type equipment purchased by Landlord to enable Landlord to supply services Landlord might otherwise contract for with a third party for where such depreciation, amortization and interest payments would otherwise have been included in the charge for such third party's services.

Negotiating Commercial Leases (Dallas – May 27, 2009)
Calculation & Recovery of Operating Expenses

General Operation Matters	Costs or expenses of leasing any item if the purchase price of such item is not properly chargeable as an Operating Expense.	This type of exclusion is often accepted by landlords.
General Operation Matters	Any other expenses not expressly included in Operating Expenses which, in accordance with generally acceptable accounting principles consistently applied, would not normally be treated as Operating Expenses by landlords of comparable buildings in the same market.	The landlord may have concern with this catch-all type of exclusion.
General Operation Matters	Costs or allocations that cannot be documented by Landlord, property manager, or their representatives.	This type of exclusion is often accepted by landlords.

C. SELECTED EXPENSE ITEMS THAT MAY BE INCLUDED AS OR EXCLUDED FROM OPERATING EXPENSES		
<u>Category</u>	<u>Example Description of Expense Item</u>	<u>Response of Other Party</u>
Capital Costs	<p>The tenant will seek to create an exclusion for “(i) all costs of a capital nature, including, but not limited to, capital improvements, capital repairs, capital replacements, capital equipment, and capital tools, which, under general accepted accounting principles consistently applied, are not regarded as operating or maintenance expenses (including but not limited to the cost of any rental or leased equipment that if purchased would be a capital expenditure); (ii) the cost of the acquisition of the property and the construction of the Building or Project property, whether initially or in connection with any replacement or expansion; and (iii) costs incurred by Landlord for structural repairs, major repairs to building systems, or latent building construction defects.”</p> <p>If a tenant is forced to accept the landlord’s language, then the tenant may seek one critical modification to the landlord’s proposed exclusion, which is altering sub-item (a) to read “to the extent that such improvements actually reduce operating expense costs of the Building/Project.” This change will significantly limit the</p>	<p>The landlord will seek important exceptions to the capital costs exclusion proposed by the tenant, such that the following would be a permitted Operating Expense: “The amortized cost of capital improvements made to the Building/Project (a) that are reasonably intended to reduce operating expense costs of the Building/Project, or (b) that are required to comply with any applicable laws, ordinances...that are enacted, or first interpreted to apply to the Building/Project, after the date of this Lease. The cost of such capital improvements shall be amortized by Landlord over the greater of (i) the Payback Period (defined below), (ii) the reasonable useful life of the capital improvement, as determined under generally accepted accounting principles consistently applied; and (iii) _____ (___) years. ‘Payback Period’ means the reasonably estimated period of time that it takes for the cost savings resulting from a capital improvement to equal the total cost of the capital improvement.”</p>

Negotiating Commercial Leases (Dallas – May 27, 2009)
Calculation & Recovery of Operating Expenses

	landlord’s discretion in passing-through the expense of a capital cost item to the tenant.	
Parking Facilities	<p>The tenant may request the following exclusion from Operating Expenses: “all fees, costs and expenses incurred in connection with the operation, leasing, repair, maintenance and management of any storage space or parking garage.”</p> <p>If a tenant is obligated to pay normal parking garage fees, then it will argue that those fees should cover its financial obligation with respect to the parking garage.</p> <p>If tenant is obligated to pay a portion of parking garage related costs as an operating expense, then such operating expense item should at a minimum be offset by all revenue generated from the use or operation of such facilities.</p> <p>The tenant might also attempt to apply a different proportionate share to this operating expense item, such as a share based on parking spaces used or available to the tenant within the garage compared to total parking spaces.</p>	The landlord may request that the following be a specifically permitted operating expense: “any fees, costs and expenses relating to operating, managing, owning and maintaining the parking garage serving the Building/Project.”

Negotiating Commercial Leases (Dallas – May 27, 2009)
Calculation & Recovery of Operating Expenses

EXHIBIT B

A RESOURCE LIST

OPERATING EXPENSES GENERALLY

Ann Peldo Cargile, Janene A. Collins & Cynthia Thomas, *What About the Little Guys? The Top Issues for a Smaller Tenant to Negotiate in its Lease*, 18 Prob. & Prop. 11, 15-16 (2004) (discussing Operating Costs issues for small tenants).

Nancy Connery, *Commercial Leases: Boilerplate Concepts*, in *Negotiating Commercial Leases: How Owners & Corporate Occupants Can Avoid Costly Errors—Fall 2006 Course Handbook* (Practicing Law Institute, 2006), *reprinted in* *Negotiating Commercial Leases: How Owners & Corporate Occupants Can Avoid Costly Errors—Spring 2008 Course Handbook*, 449–504, 490–96 (Practicing Law Institute, 2008).

Mark G. Henning, *Comments on Operating Expenses and Tenant Audit Rights*, in *Negotiating Commercial Leases: How Owners & Corporate Occupants Can Avoid Costly Errors—Fall 2007 Course Handbook* (Practicing Law Institute, 2007), *reprinted in* *Negotiating Commercial Leases: How Owners & Corporate Occupants Can Avoid Costly Errors—Spring 2008 Course Handbook*, 505–24 (Practicing Law Institute, 2008).

Richard C. Mallory, *Commercial Leases: Overview of Negotiating Solutions, Landlord and Tenant Perspectives, and Closing Strategies*, in *Ninth Annual Commercial Real Estate Institute Course Handbook* (Practicing Law Institute, 2007), *reprinted in* *Commercial Real Estate Institute (Tenth Annual) Course Handbook*, 449–88, 461 & 469–73 (Practicing Law Institute, 2008) (see Landlord and Tenant Operating Expense Negotiation Checklists).

Michael E. Meyer, *Issues in Commercial Office Leasing*, in *Negotiating Commercial Leases: How Owners & Corporate Occupants Can Avoid Costly Errors—Fall 2007 Course Handbook* (Practicing Law Institute, 2007) 565–624, 583–88 (Practicing Law Institute, 2008) (see sample Request for Proposal with extensive list of Operating Expense Exclusions).

Michael E. Meyer, *Operating Expenses and CAM/Hidden Agendas and Corporate Guerilla Warfare Tactics*, in *Negotiating Commercial Leases: How Owners & Corporate Occupants Can Avoid Costly Errors—Fall 2007 Course Handbook* (Practicing Law Institute, 2007), *reprinted in* *Negotiating Commercial Leases: How Owners & Corporate Occupants Can Avoid Costly Errors—Spring 2008 Course Handbook*, 529–64 (Practicing Law Institute, 2008).

Mark A. Senn, *Commercial Real Estate Leases: Preparation, Negotiation, and Forms* §§ 7.01–7.09 (4th ed. 2009).

Negotiating Commercial Leases (Dallas – May 27, 2009)
Calculation & Recovery of Operating Expenses

EXHIBIT B (CONTINUED)

Thomas M. Whelan, *Negotiating and Drafting Office Leases*, in *Real Estate Documents, Workouts & Closings* § 3, 1–14 (University of Houston Law Foundation 2005).

John Busey Wood, *Excerpts From Navigating the Dangerous Shoals of a Commercial Lease*, in *Negotiating Commercial Leases: How Owners & Corporate Occupants Can Avoid Costly Errors—Fall 2007 Course Handbook* (Practicing Law Institute, 2007), *reprinted in* *Negotiating Commercial Leases: How Owners & Corporate Occupants Can Avoid Costly Errors—Spring 2008 Course Handbook*, 85–178, 158–62 (Practicing Law Institute, 2008).

ESCALATIONS

Abraham P. Friedman, *Escalation Issues in Commercial Leases* 20 *Prob. & Prop.* 60, 61–63 (2006).

Raymond W. Goldfaden & William F. Treanor, *Challenges to Rent Escalation Clauses in Commercial Leases* 4 *Prob. & Prop.* 6 (1990).

Patrick T. Sharkey, *Still More Alligators Hidden in Leases—Operating Expense Increases*, 14 *Prob. & Prop.* 49 (2000).

“GREEN” RESOURCES

Richard C. Mallory, *Sample Green Building Lease Inserts*, in *Commercial Real Estate Institute (Tenth Annual) Course Handbook*, 549–56, 551 (Practicing Law Institute, 2008) (includes Operating Expenses inclusion related to “green” landscaping).

Ellen Sinreich, *Existing Office Buildings and Increasing Energy Efficiency: What Does the Lease Say?*, in *Green Real Estate Summit 2009 Course Handbook*, 105–09 (Practicing Law Institute, 2009) (discussing who pays for “green” improvements under existing lease language).

Ellen Sinreich, *The Greening of the Office Lease*, in *Green Real Estate Summit 2009 Course Handbook*, 99–103 (Practicing Law Institute, 2009) (generally covering the “greening” of an office lease).

Ellen Sinreich, *The Greening of the Retail Lease: 10 Tips for Landlords and Tenants*, in *Green Real Estate Summit 2009 Course Handbook*, 111–18, 113–14 & 117–18 (Practicing Law Institute, 2009) (see Tips #2 and #10 on the allocation of costs and benefits when “greening” a property).

Steven A. Teitelbaum, *Guide to Writing a Commercial Real Estate Lease, Including Green Lease Language* 10–15 (Lisa M. Prats & Karen W. Penafiel eds., 2008).

Negotiating Commercial Leases (Dallas – May 27, 2009)
Calculation & Recovery of Operating Expenses

EXHIBIT B (CONTINUED)

MIXED USE PROJECTS

Walter Gumbinger, *Allocation of Operating Expenses and Real Estate Taxes in Mixed Use Projects*, in *Commercial Leasing Critical Issue Roundtables* (ABA: Section of Real Property, Probate, and Trust Law 1990).

Michael K. Kuhn, *Penny Lane: Leasing Mixed Use Projects for Fun & Profit*, in *State Bar of Texas 29th Annual Advanced Real Estate Law Course*, Chapter 36 (July 2007).