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Allocating Operating Expenses in Commercial Real Estate Leases: Negotiating Strategies for Landlords and Tenants

Structuring Pass-Throughs, Exclusions, Gross-Up, and Expense Cap, and Other Operating Expense Provisions in Net and Gross Leases

THURSDAY, AUGUST 4, 2016

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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ALLOCATING OPERATING EXPENSES IN COMMERCIAL REAL ESTATE LEASES: NEGOTIATING STRATEGIES FOR LANDLORDS AND TENANTS

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August 4, 2016

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Outline of Presentation

- Brief overview of different types of lease structures
- Standard operating expense inclusions and exclusions
- Gross-up provisions
- Expense cap provisions
- Audit rights of landlord operating costs

Different Types of Lease Structures

- "Net Leases"
  - Typical in retail and industrial; less common in office.
  - In single tenant context, may allocate responsibility for work to Tenant, at Tenant's cost.
- Base Year (or "Full Service Gross") Leases
  - Typical in office leasing and sometimes in industrial.
  - Base Year is typically the first calendar year where there is 6 months after Commencement Date (so June 30 Commencement Date is typical cut off to move to next calendar year for Base Year).
  - Use of different categories to lessen impact of cost spikes in taxes, utilities or insurance costs.
  - Expense stop leases (using fixed amount as base rather than actual costs for a particular year).

Different Types of Lease Structures

- Gross Leases
  - Mostly used in short term leases/licenses.
- Hybrid (e.g., Net for Electricity or Janitorial)
  - Utility cost spikes have resulted in some landlords taking electrical costs out of Base Year.
- Fixed Contributions
  - Increasingly common in regional malls and mixed use projects to simplify cost allocations/disputes.

Standard Operating Expenses Inclusions and Exclusions

- Included items
  - General: costs of operation, management, ownership, maintenance and repair of the Project, as determined by accepted principles of sound accounting practice.
  - Utility costs and costs of janitorial, security and other services.
  - Insurance costs and deductibles.
  - Project management including management personnel costs, management office rental and management fees.
  - Costs of repairs, maintenance and replacements including costs of supplies, materials, equipment and tools required therefor.

Standard Operating Expenses Inclusions and Exclusions

- Excluded items
  - Capital expenditures - Complete exclusion or Limited inclusion with amortization of costs
  - Ground lease rent and mortgage related costs.
  - Costs reimbursed by insurance, warranties or other third parties.
  - Costs of build out of tenant spaces and leasing costs including marketing, attorneys' fees and broker commissions.
  - Depreciation or amortization (but see capital expenses).
  - Expenses in connection with services or amenities not available to Tenant or for which Tenant is separately charged.
  - Amounts paid to Landlord affiliates in excess of market rate for goods or services.
  - Landlord's overhead or administrative costs such as personnel costs above the level of Building manager.

Standard Operating Expenses Inclusions and Exclusions

- Excluded items
  - Costs relating to Hazardous Materials.
  - Costs of charitable or political contributions.
  - Costs of correction of pre-existing non-compliance with applicable laws.
  - Costs of sale, refinancing of all or any part of the Project or any interest in Landlord.
  - Increases in tax expenses resulting from a change in ownership.
  - Taxes on rent or income of Landlord.
  - Interest on late payment (other than interest on Tax Costs paid in the maximum number of permitted installments with interest).
  - Parking facility costs or costs of any other commercial operation at the Project.

Gross Up Provisions

- The purpose of a "gross up" provision is to allocate to a tenant only the amount of operating expenses which is properly attributable to the tenant's occupancy of the building. Negotiating for a gross up is appropriate where the tenant is paying for its share of operating expenses over a base year amount.
- When to negotiate for a gross up provision:

Base Year Occupancy	Landlord	Tenant
Low Occupancy		X
High Occupancy	X	

  – Regardless of who initiates the negotiation, grossing up results in a fair allocation of expenses for both landlord and tenant

Gross Up Provisions

- A typical gross up provision permits the landlord to, for accounting purposes, increase (or gross up) the amount of <u>variable</u> operating expenses to reflect 90% to 100% building occupancy
  – Variable expenses (e.g., janitorial, utilities)
  – Non-Variable (e.g., property taxes)
- A fair gross up provision should:
  – State that the landlord cannot recover more than 100% of actual expenses
  – Stipulate that the gross-up applies only to <u>variable</u> expenses and defines "variable expenses"
  – Provide that the base year and all subsequent years must be "grossed up" and the percentage should be clearly stated (typically between 90% and 100%)

Gross Up Provisions

- Example of Gross Up Provision Benefitting Landlord

	100% Gross Up		No Gross Up	
	Base Year	Year Two	Base Year	Year Two
Actual Variable Operating Expenses	$90,000	$75,000	$90,000	$75,000
Building Occupancy	90%	70%	90%	70%
Grossed-Up Variable Expenses	$100,000	$701,143	---	---
Tenant's Pro Rata Share	70%	70%	70%	70%
Tenant's Operating Expense Payment (Variable)	---	$5,000	---	$0

Gross Up Provisions

- Example of Gross Up Provision Benefitting Tenant

	100% Gross Up		No Gross Up	
	Base Year	Year Two	Base Year	Year Two
Actual Variable Operating Expenses	$21,250	$90,000	$21,250	$90,000
Building Occupancy	25%	90%	25%	90%
Grossed-Up Variable Expenses	$85,000	$100,000	---	---
Tenant's Pro Rata Share	25%	25%	25%	25%
Tenant's Operating Expense Payment (Variable)	---	$3,750	---	$17,188

Gross Up Provisions

- Grossing up the components of Operating Expenses that vary based on occupancy
- Grossing up the cost of items separately provided by one or more tenants in lieu of being provided by Landlord
- Cost pooling
- Treatment of new categories of expenses

Expense Caps

- Typically, caps apply only to controllable operating expenses, such as landscaping and cleaning expenses
- A well drafted expense cap provision should:
  - Clearly describe how the cap is to be computed and applied
  - Identify what types of expenses will be capped and clearly define those expenses if there is a limitation (e.g., “controllable operating expenses”)
  - Include a sample computation

Expense Caps

- Compounded Year Over Base Cap (a/k/a “compounded and cumulative” cap)
  - Cap percentage is compounded each year, allowing for a more rapid increase in the capped expenses
  - Landlord-friendly because it allows for the fastest increase in capped expenses, permitting the landlord to pass through more expenses to the tenant.
- Example: If base year expenses are $100,000 and the parties have agreed to a cap of 4% over the base year expenses on a compounded basis, the caps are calculated as follows:
  - Base year expenses: $100,000
  - Year 2 capped expenses: $100,000 x 1.04 = $104,000
  - Year 3 capped expenses: $100,000 x 1.0816* = $108,160

*Represents a 4% increase over the prior year’s 4% cap. Year 4’s cap will be 4% over the Year 3 cap percentage, and so on.

Expense Caps

- *Example Compounded Year Over Base Cap Language*

Cap on Controllable Operating Expenses. For the purpose of calculating Tenant's Share of increases in Operating Expenses, "Controllable Operating Expenses" (as hereinafter defined) for calendar year 20___, and each year thereafter, shall not increase by more than ____ percent (__%) per annum, on a compounded and cumulative basis, over the actual amount of such "Controllable Operating Expenses" for calendar year 20___. As used herein, the term "Controllable Operating Expenses" means all Operating Expenses, on a per square foot of Net Rentable Area basis [as "grossed up" pursuant to Paragraph ___ of this Lease], other than taxes, insurance, utilities, costs of security, costs of snow removal, costs subject to government regulation, such as minimum wages, and all costs incurred to comply with new or revised federal or state laws, municipal or county ordinances or codes or regulations promulgated under any of the same. By way of illustration of the foregoing, in calendar year 20___, the Controllable Operating Expenses shall not exceed the amount determined by the following formula, when "X" equals the actual amount of the Controllable Operating Expenses for calendar year 20___:

X times 1.0__ times 1.0__ = maximum amount of Controllable Operating Expenses for calendar year 20___.

Thus, if Controllable Operating Expenses for 20___ are $4.00 per square foot of Net Rentable Area on a "grossed up" basis, the maximum amount of Controllable Operating Expenses for calendar year 20___ would be $4.00 x 1.0__ x 1.0__ = $______ per square foot of Net Rentable Area.

Expense Caps

- Year Over Year Cap
  - Keyed to actual, prior year expenses and could therefore result in lower caps
- Example: If actual base year expenses are $100,000 and the parties have agreed to a cumulative year over year cap of 4%, the caps are calculated as follows:
    - Base year actual expenses: $100,000
    - Year 2 capped expenses: $100,000 x 1.04 = $104,000
  - If Year 2 expenses are <u>actually</u> $102,000, and the cap is not reached, then the parties will calculate the Year 3 capped expenses based on the $102,000 in actual Year 2 expenses:
    - Year 3 capped expenses: $102,000 x 1.08 = $110,160
  - If Year 2 expenses are $106,000, however, then the Year 2 cap <u>will</u> apply, and the parties will calculate the Year 3 capped expenses based on the $104,000 cap for Year 2:
    - Year 3 capped expenses: $104,000 x 1.08 = $112,320

Expense Caps

Example Year Over Year Cap Language

Cap on Controllable Operating Expenses. For the purpose of calculating Tenant's Share of increases in Operating Expenses, "Controllable Operating Expenses" (as hereinafter defined) for calendar year 20___, and each year thereafter, shall not increase by more than ________ percent (__%) per annum over the actual amount of such "Controllable Operating Expenses" for the preceding calendar year. As used herein, the term, "Controllable Operating Expenses" means all Operating Expenses, on a per square foot of Net Rentable Area basis [as "grossed up" pursuant to Paragraph ____ of this Lease], other than taxes, insurance, utilities, costs of security, costs of snow removal, costs subject to government regulation, such as minimum wages, and all costs incurred to comply with new or revised federal or state laws, municipal or county ordinances or codes or regulations promulgated under any of the same. By way of illustration of the foregoing, in calendar year 20___, the Controllable Operating Expenses shall not exceed the amount determined by the following formula, when "X" equals the actual amount of the Controllable Operating Expenses for calendar year 20___:

X times 1.0__ = maximum amount of Controllable Operating Expenses for calendar year 20___.

Thus, if Controllable Operating Expenses for 20___ are $4.00 per square foot of Net Rentable Area on a "grossed up" basis, the maximum amount of Controllable Operating Expenses for calendar year 20___ would be $4.00 x 1.0__ = $____ per square foot of Net Rentable Area.

Expense Caps

- Variations on Expense Caps
  - Cumulative Year Over Base
  - Compounding Year Over Year
  - Landlord may negotiate to recover "unused" percentage increases (in a year in which expenses are below the cap) by making up the difference later in the term if operating expenses increase above the cap
    - Example Language for this concept:

Notwithstanding anything contained herein to the contrary, if, by operation of the Controllable Operating Expenses Cap, Landlord is unable to collect the entire amount which would otherwise have been payable by Tenant as Tenant's proportionate share of increases in operating expenses with respect to any particular calendar year, then, for purposes of calculating Tenant's proportionate share of increases in operating expenses for any subsequent years of the Term, Landlord shall have the right to add the "Carryover Expenses" (as hereinafter defined) to the operating expenses for such subsequent years until the entire amount of the Carryover Expenses have been so applied, provided that in no event shall the operating expenses for any such subsequent year be increased to more than the amount of the Controllable Operating Expenses Cap for such year.

Audit Rights

- Landlord considerations
  - Limit the timing of the audit (e.g., notice of the audit must be given within ____ days of the year-end reconciliation)
  - Limit scope of audit (shorter “look back” period)
  - No auditors paid on contingency
  - Audit conducted at Tenant’s expense
  - Location of the audit
  - Require Tenant to keep results confidential
  - Possible arbitration provision
- Tenant considerations
  - Understand the time limitations
  - Negotiate for landlord to pay for audit if landlord has overcharged by __% or greater

Questions and Discussion

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