

APPENDIX B

Special Issues Related to Operating Expense Provisions in Leases
ABA Real Property, Trusts and Estates Section
Leasing Group Nuts and Bolts of Leasing Call
October 30, 2013
by
G. Andrew Gardner, McDonald Hopkins LLC (Cleveland, Ohio)

1. Operating Expenses

a. As part of any “typical” Triple-Net Lease, the Tenant will agree to reimburse the Landlord for most expenses incurred by the Landlord in connection with its operation of the building/property where the Tenant’s premises is located (“Property”).

b. Operating expense clauses are found in triple-net leases and typically include a statement that all costs related to the operation of the Property are considered Operating Expenses. Frequently a list of standard items is included in the Lease. [Note: Taxes and Landlord’s insurance often have separate provisions for reimbursement.]

- (i) Typical List of Operating Expenses: All costs and expenses of any kind, nature, and description incurred by the Landlord in connection with the maintenance, operation, care and repair of the Property which Landlord determines are desirable for the operation and maintenance of the Property in accordance with the standard maintained in the [City], [State] area for similar buildings and sites. The following types of expenses are by way of illustration and not by way of limitation of the generality of the foregoing, to wit: (1) the cost of providing all heating, ventilating, air conditioning, water and waste water services, and other utilities to the Building; (2) the cost of refuse, rubbish, and garbage collection and removal for the Property; (3) cleaning, gardening, and landscaping the Property (including, without limitation, the Common Areas); (4) costs of tie-ins or other costs for providing sanitary or storm sewers or control to and for the Property and Premises; (5) inspection and permit fees, accounting fees, and attorney and other professional fees incurred by Landlord in connection with the operation of the Property or Building; (6) repairs and replacements of the paving, curbs, fencing, walkways, electrical power lines, light poles, bulbs, drainage systems, and equipment used on the Property (including the Common Areas); (7) line painting; (8) attending the parking areas (if necessary); (9) any governmental charges, surcharges, fees, or taxes on the parking areas or parking spaces or on cars parking therein; (10) security services, including private police protection if obtained; (11) repair or replacement of on-site water lines, sanitary sewer lines, and storm sewer lines serving the Property; (12) rental of machinery, equipment, and tools used in operating and maintaining the Property, Building and/or Premises; (13) reasonable amortization or depreciation of equipment purchased and

used for operating or maintaining the Property, Building and/or Premises; (14) costs of signs, sign maintenance, and sound systems; (15) all personal property and similar taxes on equipment, machinery, tools, supplies, and other personal property and facilities used in the maintenance of the Property; (16) compensation, direct or indirect, paid to any person providing services to the Building, including the classification of building superintendent; (17) all repairs to the Property, Building or Premises; (18) all supplies and replacement items required for the Property, Building or Premises; (19) all costs for restoration, relocation or expansion of the Common Areas of the Property; (20) all charges for maintenance contracts, inspection contracts, elevator contracts and similar contracts for the Premises; (21) management charges for the operation of the Premises not to exceed _____ percent (___%) of gross rentals; and (22) elevator service.

c. A list of exclusions is typically requested by Tenant's counsel.

- (i) Typical List of Exclusions. Operating Expenses shall expressly exclude: (1) costs of maintenance and repair reimbursed by insurance proceeds; (2) alterations or other specific costs attributable solely to other tenants' space in the Building and billed to such tenants; (3) leasing commissions, advertising expenses and other costs incurred in leasing space in the Building; (4) debt service (or ground lease payments, if applicable), interest on borrowed money or debt amortization; (4) depreciation on the Building or equipment or systems therein; (5) Real Estate Taxes; (6) attorneys' fees and expenses incurred in connection with lease negotiations or Lease disputes; (7) the cost (including any amortization thereof) of any improvements or alterations which would be properly classified as capital expenditures according to generally accepted accounting principles; (8) the cost of decorating, improving for tenant occupancy, painting or redecorating portions of the Building to be demised to tenants; (9) executive salaries above the title of general manager; (10) advertising; (11) the costs of artwork or sculpture; (12) costs for repairs or other work occasioned by fire, windstorm or other casualty; (13) wages, salaries or other compensation paid for clerks or attendants in concessions or newsstands operated by Landlord or Landlord's affiliates; (14) costs or expenses charged to or payable by tenants of the Building (including utility charges); (15) expenses in connection with services or other benefits of a type not provided to Tenant, but provided to another tenant or occupant of the Building; (16) any costs or expenses which are otherwise reimbursed to Landlord; (17) overhead and profit increments paid to subsidiaries or affiliates of Landlord for services on or to the Building to the extent such costs exceed the market cost for such services; (18) charitable or political donations or contributions; or (19) interest, charges or penalties arising by reason of Landlord's failure to timely pay any Real Estate Taxes or Operating Expenses.

See also Exhibit A for a more comprehensive list of exclusions.

2. Calculation of Operating Expenses.

a. Pro-Rata Share. Tenants typically pay a proportionate share of the Operating Expenses for a Building/Project/Shopping Center based upon a fraction that is typically expressed as follows:

$$\frac{\text{Square Footage of Premises}}{\text{Total Square Footage of Property/Building}}$$

Typically referred to as the Tenant's "Pro-Rata Share" or "Proportionate Share"), this percentage (calculated from the fraction above) may be agreed to in the Lease or subject to measurement following construction using industry standards (such as the Standard Method of Measuring Floor Area in Office Buildings, ANSI Z65.1 – 1996, commonly known as the "BOMA Standard") if the Premises are being altered or constructed. Standards like the BOMA Standard are known in the industry and can be used by an architect to calculate the square footage of the Premises and the Building to determine the Pro-Rata Share.

b. Changes in Measurement Standards. If a measurement standard is used, beware of granting the Landlord the ability to require a re-measurement of the Building in the absence of a physical alteration of the Building. Some people joke about buildings in some cities that have grown by thousands of square feet without any addition to the Building, due to changes in measurement standards. The re-measurement could take into account space not allocated to tenants under the current standard, resulting in an increase in the numerator (as well as the percentage share) which will increase the Tenant's Operating Expense payment. It is often best to provide that once the initial measurement is complete, absent manifest error, there will be no future measurement to the Building unless a significant addition is made. This provides comfort to the Tenant that there will not be a jump in expenses due to changed measurement.

c. "Gross-Up" Provision. Typically included within the Operating Expense provision is a "gross-up" provision. For example:

"If the Building is less than 95% occupied or in the event Landlord is providing services to less than 95% of the Building during any calendar year, the Operating Expenses for the year in question shall be adjusted to reflect a ninety-five percent (95%) occupancy or service level, as the case may be, of the Building."

Application of the "gross-up" provision typically results in the Tenant paying a larger share of the Operating Expenses incurred by the Landlord due to the artificial absorption of unoccupied space in the Building. For example, if a Building is at full (100%) occupancy, and the Landlord incurs costs per square foot equal to \$20.00, a Tenant occupying 20% of the Building would be paying \$4.00 per square foot for Operating Expenses (see the following example:

Fully Occupied Operating Expenses:	\$20.00
Tenant's Pro-Rata Share (20%):	\$ 4.00
Other Tenant's Operating Expenses (80%):	\$16.00
Amount Remaining for Landlord (0%):	\$ 0.00

If the Building is not fully occupied, for example if only 80% of the Building is occupied, and the Landlord's actual Operating Expenses (due to the Building being less than fully occupied) are \$16.00 per square foot (without gross up), the 20% Tenant's Operating Expenses would be \$3.20 per square foot.

Partially Occupied Operating Expenses:	\$16.00
Tenant's Pro-Rata Share (20%):	\$ 3.20
Other Tenant's Operating Expenses (60%):	\$ 9.60
Amount Remaining for Landlord (20%):	\$ 3.20

Instead, if the Landlord is permitted to apply the "gross-up" provision above, which would assume that the cost per square foot is \$19.00 (95% of the \$20.00 full occupancy costs) even though the actual Operating Expenses are \$16.00, the Tenant's per square foot charge increases from \$3.20/per square foot to \$3.80 per square foot.

Partially Occupied Operating Expenses:	\$16.00 are "Grossed Up" to \$19.00 (95% of \$20.00)
Tenant's Pro-Rata Share (20%):	\$3.80 (20% of "Grossed Up" \$19.00)
Other Tenant's Operating Expenses (60%):	\$11.40 (60% of "Grossed Up" 19.00)
Amount Remaining for Landlord (20%):	\$0.80 (\$16.00 minus \$3.80 and \$11.40)

The Tenant's attorney should request that only costs that vary with occupancy be permitted to be grossed-up (for example, utilities or management fees). Items such as building staff, window washing, landscaping and snow removal should not be grossed up. Finally, costs that are grossed up are not permitted to exceed Landlord's actual cost for such items.

Why are "Gross-Up" Provisions included? Because they even the playing field. When an Building/Project/Shopping Center is not fully occupied, the vacant areas (where the Landlord bears the expense burden) are not incurring expenses in the same manner that Tenant-occupied space is incurring expenses and, without this provision, the lease disproportionately places costs on the Landlord. Also, if the Tenant has a Base Year, it helps avoid "spikes" in future Operating Expense years due to increases over the "ungrossed" Base Year and provides productability in the amount of payments.

3. Audit Provisions.

a. "False" Review Provisions. Beware of Audit Provisions that do not provide a remedy. More frequently than you would expect, the audit provision states that the Tenant can audit the records, but does not provide for any adjustment if the Operating Expense payments by the Tenant were higher than estimated by Landlord.

“If Tenant disputes the amount set forth in the Final Statement, Landlord shall make available to Tenant Landlord’s books and records with respect to the calendar year which is the subject of the Final Statement to be reviewed by Tenant. Such review shall take place at the offices of Landlord where its books and records are located at a mutually convenient time during Landlord’s regular business hours.”

The provision should also provide:

“If the parties agree to the results of Tenant’s review of the Final Statement, Tenant’s Final Statement shall be appropriately adjusted (and any overpayment credited or refunded to Tenant) based upon the results of such review, and the results of such audit shall be final and binding upon Landlord and Tenant. If the parties do not agree upon the Tenant’s review or the inclusion or amount of any Operating Expense charged by Landlord, the sole remedy of Tenant shall be to submit the matter to arbitration within thirty (30) days after completion of the review to request an adjustment to any disputed Operating Expense or Final Statement. Tenant agrees that the results of any Operating Expense audit shall be kept strictly confidential by Tenant and shall not be disclosed to any other person or entity.”

b. Review Time. Provide your client with sufficient time to review. For most clients 60-90 days is sufficient.

c. Refunds: Operating Expense refunds should be in cash payments. The Tenant provided cash and should receive its refund in cash. Most Landlords will initially only provide that any overpayment by Tenant be credited toward the next payment/payments due under the Lease unless the Lease has expired.

d. Contingency Fees: Landlords typically restrict the right to use independent accounting (or other) firms that charge a fee equal to a percentage of the amount of Tenant’s savings as a result of the audit (contingency fee arrangements) as the Tenant does not have any “skin in the game”. It is important to distinguish the Landlord’s language with this restriction to be able to use a firm that sometimes uses contingency fees (but is not in the case of your client) vs. a restriction against using a firm that charges contingency fees so they may not be used. For example:

Contingency Example 1:

“Tenant shall not engage any firm that charges fees on a contingency basis to review the Landlord’s calculation of Operating Expenses.”

Contingency Example 2:

“Tenant shall not engage a firm charging fees on a contingency basis to review the Landlord’s calculation of Operating Expenses.”

You will note that the first provision is much broader in that it restricts the use of a firm that charges contingency fees, even if that is not the method being used for calculation with respect to your client, whereas the second provision restricts your client using a firm on a contingency basis.

e. Reimbursement of Audit Fees.

In the event that Landlord's charges to Tenant for Operating Expenses exceeded an amount agreed upon by Landlord and Tenant to be a fair margin of error (typically between 3%-10% of the total amount of Operating Expenses charged to Tenant), Tenant's counsel will request that the Landlord pay Tenant's expenses related to the audit.

Notwithstanding the foregoing, in the event that the results of Tenant's Audit determine that Landlord's Operating Expense Calculation exceeded the amount of Tenant's actual Operating Expense Payment (as determined by Tenant's Audit for the applicable calendar year): (i) by more than _____ percent (__%), then Landlord shall bear the reasonable costs of Tenant's Audit (ii) by _____ percent (__%) or less, then Tenant shall bear all costs of Tenant's Audit.

Exhibit A

Operating Expense Exclusions (another form)

- a. Taxes, as defined in Section [Real Property Tax provision],
- b. franchise, or income, or other taxes imposed on Landlord,
- c. all leasing costs including appraisals, accounting or legal fees, and leasing and mortgage brokerage commissions,
- d. the cost of electrical energy and condenser water furnished directly to space leased or available for leasing to tenants and any survey costs or metering costs or meter reading costs in connection therewith,
- e. cost of tenant installations and decorating incurred in connection with preparing space for a new tenant;
- f. accounting costs or legal expenses or other out-of-pocket costs incurred in connection with leasing space in the Building or enforcing obligations of tenants under space leases or for negotiations relating to existing leases or proposed space leases in the Building including court costs and disbursements;
- g. depreciation or amortization of the Building or its equipment (except as expressly provided for in this Lease);
- h. expenses incurred by Landlord for the repair of damage to the Building;
- i. interest, principal (and ground rent on any ground lease), points and fees, amortization or other costs with respect to any mortgage, loan or refinancing of the Building or the Land;
- j. the cost of installing, operating and maintaining any specialty service such as an observatory, broadcasting facilities, luncheon club, athletic or recreational club, child care or similar facility, auditorium, cafeteria or dining facility or conference center, or making any additions to, or building additional stories on, the Building or its plazas, or adding buildings or other structures adjoining the Building;
- k. costs incurred in performing work or furnishing services for any tenant or tenant's space (except to the extent that Tenant would have to pay a separate charge therefor if Landlord were providing the service to Tenant (e.g., overtime air conditioning));
- l. capital improvements, except however that if any new capital equipment results (provided satisfactory proof of such saving and a consultant's certification of the amount thereof is provided to Tenant) in reducing any Operating Cost, then with respect to the calendar year in which the improvement is made, and each subsequent calendar year during the term of the Lease, Landlord may include in Operating Cost the straight-lined amortized (over the useful life of the

new equipment) cost of such capital improvement but not in excess, in any Operating Cost, of the amount by which the Operating Cost have been reduced for such Operating Cost Year;

m. the cost, if any, of inspection or removing, remediating, abating or otherwise treating asbestos or any other hazardous material or waste in the Building;

n. salaries, including, without limitation, wages, fringe benefits and all other compensation, of personnel above the grade of building manager and such building manager's supervisor;

o. repairs or other work occasioned by fire, windstorm or other insured casualty or hazard or any other expense for which Landlord is otherwise compensated through the proceeds of insurance (or would have been so compensated but for Landlord's failure to maintain the insurance required hereunder), or through reimbursement by any tenant or anyone else (including Tenant), or any expense of the Building for services in excess of the services Landlord is obligated to furnish to Tenant hereunder;

p. Landlord's advertising, entertainment and promotional costs for the Building;

q. the portion of any fee or expenditure paid to any Affiliate of Landlord which exceeds the amount which would be paid for comparable services and/or goods in the absence of such relationship;

r. auditing fees and other expenses incurred in connection with tenant (including Tenant) disputes;

s. repairs or rebuilding necessitated by condemnation;

t. to the extent any costs that are otherwise includable in Operating Cost are incurred with respect to the Building and other buildings owned or managed by Landlord, the amounts that are properly allocable to such other buildings shall be excluded from Operating Costs;

u. Operating Costs attributable solely to storage space in the Building;

v. Costs (including any legal fees, transfer taxes, mortgage recording taxes and other transaction costs) incurred in connection with the financing or refinancing of the Property, or a sale or transfer of all or any portion of the Property (including the acquisition or sale of air rights, transferable development rights, easements or other real property interests) or any interest therein or in any Person of whatever tier owing an interest therein;

w. costs and expenses incurred in connection with the enforcement of leases or other occupancy agreements, including court costs, accounting fees, auditing fees, attorneys fees and disbursements in connection with any summary proceeding to disposes any tenant;

x. costs and expenses incurred in connection with procuring tenants, including lease concessions, lease takeover or rental assumption obligations, architectural costs, engineering, fees and other similar professional costs and legal fees in connection with lease negotiations;

y. damages and attorneys' fees and disbursements and any other costs in connection with any proceeding, judgment, settlement or arbitration award resulting from any liability of Landlord and fines or penalties due to Landlord's negligence or wrongful acts;

z. any compensation paid to clerks, attendants or other persons in commercial concessions operated by Landlord (or its affiliates) not for the general benefit of all tenants of the Building;

aa. any interest, fines, late charges or similar punitive obligations incurred by Landlord because of the failure to cure with reasonable diligence the violation of any Laws which violation is the responsibility of Landlord to cure pursuant to this Lease;

bb. the cost of acquiring, leasing, installing, maintaining displaying, protecting, insuring, restoring or renewing works of art or temporary exhibitions located at or within the Building;

cc. costs relating to withdrawal liability or unfunded pension liability under the Multi-Employer Pension Plan Act or other Requirement;

dd. all costs, including, without limitation, the cost of repair made by Landlord to remedy damage caused by or resulting from the gross negligence, willful misconduct, or improper acts of Landlord, its agents, servants or employees, contractors, or suppliers;

ee. legal expenses, accounting and other professional service costs not allocable to the Operation of the Property;

ff. costs of overtime HVAC service provided to any other tenant of the Building;

gg. any bad debt loss, rent loss or reserves for bad debt or rent loss;

hh. any Operating Costs incurred exclusively to service retail space of the Building;

ii. all costs incurred by Landlord with respect to goods and services (including utilities sold and supplied to tenants and occupants of the Building), to the extent that Landlord shall be entitled to reimbursement from any tenant in the Building, including Tenant, for the cost of like goods and services furnished to Tenant pursuant to this Lease other than in the nature of Operating Costs;

jj. increases in Operating Costs attributable to changes in the percentage used for determining management fees in excess of _____;

kk. all rentals of capital equipment to the extent same would not be an Operating Costs if such equipment were purchased;

ll. all costs associated with Landlord's political, civic or charitable contributions;

mm. Landlord's general corporate overhead and expenses and general and administrative expenses;

- nn. the capital cost of any physical additions to the Building after the date hereof; and
- oo. any expenses for repairs or maintenance which are covered by warranties and service contracts and such expenses are reimbursed to Landlord pursuant thereto.
- pp. decorating space leased to any occupant or held available for lease;
- qq. the cost of any item to the extent the Landlord is actually reimbursed by insurance or pursuant to a warranty;
- rr. any additional costs incurred by Landlord to operate or maintain the Building due to the particular nature of business conducted by any tenant(s) within the Building which would not customarily be incurred in a comparable Building including, but not limited to, any such costs that would not customarily be incurred in a comparable Building in connection with any retail stores or retail space or retail operations, and/or any specialty services in the Building or food service tenants; and
- ss. any and all costs, charges and expenses incurred by Landlord in connection with any change of any company providing electricity or other utility service or telecommunication services to the Building Project, including, but not limited to, maintenance, repair, installation or services and costs associated therewith.