OPERATING EXPENSES AND AUDIT ISSUES

I. BACKGROUND

A. Why This Is Important. With limited exception, all building owners incur some expense in connection with the ownership and operation of a building in which it leases space to tenants. The landlord and tenant (also with limited exception) agree to share these expenses in some manner during the term of the tenant’s lease. The “types” of expenses associated with the ownership and operation of a building may be divided into many subcategories and along many different lines. For example:

- ownership vs. operation
- maintenance vs. repair vs. replacement
- fixed vs. variable
- capital vs. ordinary
- mandatory vs. discretionary
- controllable vs. uncontrollable

The numerous ways in which one may categorize the specific expenses associated with the ownership and operation of a building influences and informs the negotiation of the particular cost sharing agreement between the landlord and tenant in any lease. Typically, the landlord and tenant negotiate a cost sharing agreement, whereby the total “rent” payable by the tenant under the lease is equal to the sum of two components: (i) an amount fixed at the beginning of the term (“base rent” or “fixed rent”), plus (ii) the tenant’s “share” of [increases in] a subset of landlord’s expenses associated with the ownership and operation of the building which, presumably, have not already been factored into the base rent amount (“rent escalations” or “additional rent”).

This subset of ownership and operation expenses is often referred to in a lease as Operating Expenses, and the scope of the definition of Operating Expenses can have significant financial consequences to both the landlord and the tenant and the economics of any lease transaction. It is, therefore, one of the more significant provisions of a lease. The actual Operating Expense provision itself, however, is often a lengthy and comprehensive provision, including complex mathematical formulas and highly detailed defined terms running for pages and, consequently, may not always receive the focus, understanding and negotiation that is warranted in light of its potential and likely impact. Alternatively, it is dealt with in an imprecise and generalized manner that is overlooked. This “perfect storm” of circumstances leads to a result in which the Operating Expense provision becomes the focus of a great deal of attention after the term has begun, setting the stage for a probable lease dispute – something which all parties wish to avoid.

B. The Terminology: Net Lease/Triple Net Lease/Modified Gross Lease. The most important lesson to take from these materials is that the terms referenced above are neither clearly defined nor universally accepted. In researching this topic, I came across a

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1 Disclaimer: This document specifically focuses on Operating Expenses in the multi-tenant commercial office building. It does, however, have limited applicability in other commercial leasing contexts.

2 For purposes of this document, Operating Expenses will be treated separately from real estate taxes applicable to the building.
A lease that includes a cost sharing arrangement is often referred to as a “Net Lease,” “Triple Net Lease” or “Modified Gross Lease.” The distinctions among the different terms are based on several factors, including whether (i) the tenant is paying its share of all Operating Expenses (often called a “Net Lease” or a “Triple Net Lease”, depending on the breadth of the definition of Operating Expenses) or (ii) the tenant is paying its share of increases in Operating Expenses to the extent they exceed a “predetermined amount” (often called a “Modified Gross Lease”). The predetermined amount may be a set dollar amount (often called an “expense stop”) or may be an amount not yet known but agreed to include all Operating Expenses for a predetermined period of time (often called a “base year”).

C. The “Gross Lease” and Its Lessons. The alternative to a “cost sharing arrangement” is for either party to the lease to bear all of the costs of ownership and operation of the building. A lease where the tenant is to bear all such costs, is rare, and is typically limited to single tenant buildings, where the tenant also assumes all obligation and responsibility arising from the ownership and operation of the building. A lease where the landlord bears all such costs, is commonly referred to as a “Gross Lease,” and is highly unusual (if not extinct) in the multi-tenant office lease context. An analysis of the Gross Lease concept, however, and its failure adequately to protect the interests of the landlord, is a helpful tool in focusing on, understanding and negotiating the cost sharing concept in a multi-tenant lease, and in advocating on behalf of the landlord or the tenant in any such negotiation.

The Gross Lease concept has an initial appeal to both landlords and tenants, namely, the certainty that the rent payable by the tenant for the leased space is fixed throughout the term. If there is a change in the market rental rate for the leased space during the term, the amount of rent payable is not affected. Consequently, the tenant benefits in a rising market, and the landlord benefits in a declining market. In addition, a Gross Lease provides the commercial tenant with certainty as to its business operating costs and insulation from inflation and rising building operating costs because, unless the lease provides otherwise, regardless of any increase in the landlord’s ownership and operation costs, the tenant’s rent remains fixed. Conversely, the commercial landlord receives the benefit of a fixed rental stream in order to cover its ownership and operation costs and to ensure an acceptable rate of return on its investment. If the landlord’s ownership and operation costs are less than the landlord predicted at the time the rent was fixed, then all savings accrue to the landlord.

While the certainty of fixed rent in a Gross Lease provides a benefit to both parties and, arguably, provides an incentive for the Landlord to operate its building in the most efficient manner possible, the arrangement can prove problematic for the landlord. Under a Gross Lease, the landlord’s rate of return on its investment directly correlates to the landlord’s ability accurately to predict future costs of ownership and operation during the term of any particular lease, while taking into account the maximum amount of fixed rent that the rental market will support.

Ultimately, the lack of predictability of the landlord’s ownership and operation costs, among other factors, has led to the rejection of the Gross Lease and the widespread use of the
“Net Lease” or “Modified Gross Lease,” whereby the landlord attempts to reduce the risks associated with such unpredictability by sharing these risks with the tenant.

As the term “Operating Expenses” implies, what has evolved in practice, is a negotiated cost sharing arrangement that “theoretically” keeps the risk of increases in “costs of ownership” with the landlord, and shifts the risk of increases in “costs of operation” to the tenants. The spectrum of what is a “cost of ownership” and what is a “cost of operation” may be clear at either end, but can be quite indeterminate along its middle. It is precisely this task, of determining where and when a cost in the middle of the building expense spectrum is more appropriately an ownership cost or an operating cost (or, said differently, whether such cost is more appropriately a landlord expense or a tenant expense), with which the parties to a lease, and their advisors, are faced in drafting, reviewing and negotiating the Operating Expense provision of a lease.

II. REVIEWING THE LEASE

A. Overall Goals.

1. Landlord’s Goals. The first version of the lease is typically drafted by the landlord and is often a form of lease that pre-existed the transaction at hand. It may or may not have been drafted with a particular building in mind. Landlord’s priority is to preserve an acceptable rate of return.

   a) Flexibility. Landlords seek to define Operating Expenses as broadly as possible in order to provide the landlord with maximum flexibility to pass through any and all building costs. Some costs may not be foreseeable when the lease is signed.

   b) Permissive language. Defining Operating Expenses broadly, merely permits a landlord to pass through such costs, it does not mandate that they be passed through.

   c) Changes in the law and/or custom. What is considered an “appropriate” or “market” building expense to pass through may change over time during the course of the term.

   d) Changes in ownership. The current landlord may want to change its management and accounting practice. Many tenants will agree to pay more for increased services. A purchaser of the building may have different practices than the owner/landlord at the time the lease was signed.

   e) Ensure charges to Tenant will never decrease. The lease will also be drafted in a manner such that rent will never decrease (even if landlord’s costs decrease).

2. Tenant’s Goals. The tenant has selected a particular location to lease based on several factors, which likely include relative cost, location, and suitability. The tenant’s priority is to preserve the economics of the transaction anticipated when deciding upon this particular location.
a) **Compare “apples to “apples:** In calculating the relative cost, the tenant must be sure that when comparing different locations, it is comparing “apples to apples” and that, in addition to considering fixed rent and other allowances that may be included, it has also included in its calculations the likely rent escalation charges. For example, a lease may have a very low fixed rent amount, but the rent escalation may be based on tenant paying its share of all Operating Expenses on the building rather than increases only.

b) **Due Diligence.** While the marketing materials for any particular location may provide estimated annual rent escalation charges, typically the landlord will not bind itself to the estimate, unless the parties negotiate a specific cap on escalations. Thus, with the estimate in hand, a tenant must conduct its own due diligence on the location in order to get comfort on the likely rent escalation. This may include investigating the historic Operating Expenses charges for the building, the landlord’s reputation and experience in building management, and a careful review of the lease itself.

c) **Carve-back the over-inclusive definition of Operating Expenses.** The tenant will seek to exclude inappropriate charges, including costs attributable to “ownership.”

d) **Preserve Tenant’s right to review landlord’s calculations.** The tenant will want the right to perform some form of “audit” of landlord’s compliance with the lease, short of litigation and discovery.

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**B. Anatomy of the Operating Expense Provision.**

1. **General Statements of Intent.**

a) **Landlord:** “The parties acknowledged that this is a net lease, and the fixed rent set forth above is intended to be payable to the Landlord net of all costs and expenses of ownership and operation of the Building.”

b) **Tenant.** “In no event shall Landlord be entitled to collect hereunder more than Tenant’s Proportionate Share of the actual Operating Expenses incurred by Landlord with respect to the Building in the year in question.”

While both of these sentences appear to bolster the individual intent of each of the parties, they are imprecise summaries of intent and may serve to override the very specific provisions that have been agreed to in the Operating Expenses provision.

2. **Defining “Operating Expenses.”**

a) **Tenant response to Landlord’s over-inclusive definition.** In response to the landlord’s imprecise and (often admitted) over-inclusive and broad definition of Operating Expenses, the tenant might propose the following limitations the landlord’s ability to pass through costs to the tenant. Tenant may require that any such costs be:

- “necessary”
- “reasonable”
• “customary”
• “in accordance with sound management practice”
• “in accordance with landlord practices in other first class buildings in the geographic area of the premises”
• “in accordance with GAAP (generally accepted accounting principles)
• “in a manner consistently applied”
• “in a manner uniformly applied” (among all tenants)

From the landlord’s perspective, it is difficult to argue to retain the right to pass through “unnecessary, unreasonable or non-customary” costs. Such language additions appear relatively harmless and have a superficial appeal, particularly for parties seeking to make sense of an otherwise complex concept. The addition of even one of these words or phrases, however, may provide the tenant with significant and, possibly unanticipated, rights and opportunities to dispute the Operating Expense being passed through to the tenant under the lease.

From the tenant’s perspective, the term “consistently applied” is a very significant limitation that it should require be included in the provision, particularly when the rent escalation is based on increases over a base year. For example, if a general category of costs was not included in the base year, due to specific change in management practice, a change in ownership, or for any other reason, and the ownership now seeks, in a year subsequent to the base year, to include this general category in Operating Expenses, then, in essence, the tenant will be paying 100% of the cost, rather than increases over the base year.

b) Landlord’s non-exclusive list of expressly included Operating Expenses. In addition to the broad definition of Operating Expenses proposed in the landlord’s form of lease, the form may also provide a non-exclusive list of specific operating expenses and categories thereof that are expressly included in Operating Expenses. This list serves as a specific agreement by the parties as to certain expenses, and may prove helpful when dealing with the indeterminate areas where ownership costs and operating costs overlap. From the landlord’s perspective, the lease must state that it is expressly intended that the list not be interpreted as limiting the preceding broad definition of Operating Expenses.

c) Tenant’s list of Operating Expense exclusions. Tenant, on the other hand, will seek (i) to confirm those expenses that both parties will most likely agree are not appropriate to pass through to a tenant under an Operating Expense provision, even though the broad definition would permit it, and (ii) to clarify the so-called indeterminate areas of Operating Expenses, in its own interest. It is important that this list be drafted to apply notwithstanding any conflict with landlord’s proposed definition, because it will inevitably conflict with the proposed definition.

i) The former type of exclusion includes several categories, some of which are:

- Ownership costs: debt service, ground lease rent, depreciation, costs to maintain the corporate formation of the landlord entity, additions to the rentable area of the building.
Costs that benefit or relate to other tenants (to the exclusion of this tenant): leasehold improvements, special or disproportionate consumption of services; overtime HVAC; utilities where separately metered to tenant, lease disputes, broker’s commissions.

Reimbursed/Reimbursable costs: costs paid by (or payable by) insurance, other tenants or third parties.

Costs caused solely by Landlord’s actions: late fees or penalties for landlord’s late payments; landlord’s negligence, willful misconduct or breach of contract; landlord’s legal fees; landlord’s payments to affiliates that are greater than would be payable in an arm’s length transaction.

ii) The latter type of exclusion includes several categories which are often the subject of debate, some of which are:

- Capital Expenditures. A Capital Expenditure is generally defined by GAAP as a material expenditure that either extends the life of the asset beyond its original life or increases its value. A distinction can be made between capital repairs, capital replacements and capital improvements.

  Amortization. No matter what specific capital items are negotiated as permissible pass-throughs, the parties will usually agree that only an amortized portion of the expenditure (over its useful life) plus an agreed upon interest factor may be passed through in any year during the term. The determination of the useful life may be in accordance with GAAP or as determined by the landlord.

- Tenant perspective: No Capital Expenditures should be included in Operating Expenses. Base rent should factor in most capital expenditures. Base Rent is payment to the landlord for the use of the building (and its structure, roof and all mechanical systems) and was calculated to account for the full depreciation of the landlord’s investment. When the building has been fully depreciated, then the landlord should replace that which was covered by the rent paid by tenant. To charge the tenant for such costs through Operating Expenses will be a duplicative payment to the landlord. Capital Expenditures are more appropriately “ownership costs” that should not be passed on to tenants.

- Landlord perspective: These costs were not factored into base rent because they were not foreseeable and are necessary for the sound operation and management of the building. The tenant is receiving a benefit from the Expenditure and should be obligated to pay its share.

- Compromise. In certain situations where a Capital Expenditure is perceived to provide a benefit to the tenant, and it was
unforeseeable at the time of lease execution, it is common for the parties to agree that certain capital expenditures may be passed through as an Operating Expense:

1) **Savings.** When the Expenditure results in (or is intended to result in) a savings in Operating Expenses, the parties often agree that they may be passed through as an Operating Expense. A landlord will want to be able to pass the cost though if savings is “intended” by the expenditure, regardless of the outcome. A landlord does not want to be held to have guaranteed a savings. A tenant will want there to be an actual savings and will want to limit to amount of the amortized portion of the Expenditure that may be passed through in any year to the actual savings accrued.

- Tenant’s should beware of the distinction between savings in operating expenses resulting from replacement of capital items at the end of their useful life, which arguably should be treated differently from (and, therefore excluded from Operating Expenses) capital improvements resulting in savings (i.e., new capital items) that are exclusively designed to reduce costs.

2) **Compliance with Laws.** When the Expenditure is required by laws that were not in force at the time the Lease, the parties often agree that they may be passed through as an Operating Expense. Examples of the types of laws that may be implicated by this provision include environmental laws, fire and safety codes, and accessibility laws. Changes that are required after the lease was signed were likely not foreseeable (and therefore were not factored into base rent).

- **Management Fees.**
  Management Fees are typically equal to a percentage of revenue.
  
  - **What is the percentage used?** If the landlord is self-managed the percentage is normally predetermined. The tenant should consider whether this percentage is greater that the current rate for an arm’s length, third party management contract for comparable buildings in the geographic area.
  - **How is “revenue” defined?** Does it include fixed rent plus additional rent? Does it include amounts actually paid or is it grossed up if the building is vacant

- **Costs related to events for Building tenants.** While such expenses may benefit the tenant, and all tenants of the building, these are strictly voluntary expenditures and are more appropriately categorized as marketing expenses.

- **Costs attributable to a Parking Garage/Commercial Concession.** Where a landlord charges a parking fee in addition to rent, then any costs attributable to ownership and operation of the parking garage should be offset against the revenue from the parking fee, and should not be an Operating Expenses. Typically the landlord reserves the right to
increase the parking charge and, thereby, protects itself from increases in garage operating expenses. Additionally, in calculating the tenant’s proportionate share (see discussion below) the area of the garage is normally not factored into the denominator. Finally, parking garages are often open to the public either for free or for a charge, unlike other common areas for which tenant pays its proportionate share.

- **Landlord’s leasing costs for its management office at the Building.** A tenant can argue that if the landlord has any vacancy in its building then there is, in fact, no cost to the landlord to maintain this office.

- **Costs shared among other properties.** Landlord’s have a genuine interest in allocating operating costs to the extent a service is shared among several of its properties in a combined project. This should not create a problem for a tenant as long as the lease clearly states that any such costs are equitably allocated among the properties. The level of clarification of the manner in which such costs will be allocated is largely a factor of leverage. For example, if an employee spends half of its time at one property and half of its time at another, then 50% of that employees wages may be included as an Operating Expense. If a service provider charges based on rentable area, then the costs should be allocated among the properties accordingly.

3. **Calculation of Tenant’s Payment.**

a) **Base Year vs. Net Lease:** In a Modified Gross Lease, in which a base year is used, the tenant pays its proportionate share of Operating Expenses to the extent that they exceed the base year.

- The tenant wants the base year to be as late as possible and as high as possible. If the lease term includes the base year, then Tenant will not start paying rent escalations until sometime later in the term.

- It is typically a calendar year, although landlords may reserve the right to change its accounting to some other 12 month period. Tenants should be clear that any such change will have no impact on Tenant’s Share of Operating Expenses.

- Tenants should review the details of the base year Operating Expenses to be sure that the items included are a comprehensive set of charges. Failure to include a category of cost may cause the base year to be artificially low.

- Base years can also be artificially low when the building is not fully occupied during the base year (see Gross Up discussion below), or during the years following initial construction when certain maintenance costs are covered by warranties that will not be in effect in later years.

- Landlords should carefully consider whether the base year contains any extraordinary cost or expense such that the numbers are artificially high and, therefore, do not represent a typical operating year. Some landlords do not include capital expenditures in a base year. Tenants will counter that if that is
the case with the base year, then similar costs should be excluded in subsequent years.

b) Tenant’s Proportionate Share.

- Typically tenant’s share is based on a fraction, the numerator of which is the rentable area of the leased premises and the denominator of which is the rentable area of the building.

- Typically the area numbers are based on rentable area, rather than usable area. Rentable area is a form of measurement that includes not only the usable area of the leased premises, but also includes a share of certain other common areas in the building.

- Tenant should reserve the right to confirm any such rentable area measurement. Landlord will want the tenant to agree that the measurement is correct at the time it signs the lease. At the very least a tenant should attempt to confirm which standard of measurement was used in determining the rentable area. The most widely accepted standard is the BOMA (Building Owners and Managers Association) method.

- Tenants should be sure that the numerator and denominator are the same unit of measurement.

- Landlords often try to reserve the right to change the rentable area of the building, where expansion is likely. If expansion occurs, the lease should provide that tenant’s share will decrease (i.e., the denominator will increase).

- In a situation where the leased premises will not be fully constructed or demised until after the lease is signed, then tenant’s proportionate share will be based on the measurement following completion. Tenant may want to restrict the range of fluctuation in measurement to a certain percentage from what was estimated to be the area of the premises. Additionally, the tenant may want to reserve the right to confirm the measurement of its premises following construction. If the parties have agreed to an objective measurement standard, then the landlord is likely to agree to this.

c) The “GROSS UP” Clause. One of the most perplexing areas of the Operating Expense provision of a lease is the Gross Up clause. In theory, this clause serves only to make the rent escalation under a lease fair and equitable and in accordance with the expectations of the parties. As a result should be a relatively neutral clause.

- Grossing Up expenses is a method of extrapolating certain expenses that vary based on occupancy where the building is not fully leased, so that the tenant’s proportionate share of the expenses accurately reflects the expectations of the parties. The landlord’s justification is that the calculation of Tenant’s Proportionate Share is based on a share of the building as a whole and, therefore, the amount of the expense should be extrapolated to that which would have been incurred if the building as a whole was leased.
Tenants should be sure that both the base year and escalation base years are “grossed up” and that only Operating Expenses that vary by occupancy should be grossed-up.

Gross Up clauses are necessary because of the manner in which Operating Expenses get passed through to tenants, whose proportionate share is typically a set percentage. The best way to explain the gross up clause is through an example.

**EXAMPLE:** Certain operating costs vary based on the level of occupancy of a building. One example of this is janitorial service. Janitorial contracts typically take into account the rentable area being services. Assume the following: 1) Tenant A is leasing 25,000 rentable square feet of a building containing 100,000.00 rentable square feet. 2) The janitorial costs are $1.00 per rentable square foot cleaned and such costs are includable under the Lease as an Operating Expense. 3) The building is fully occupied. In this case, the janitorial costs for the building are $100,000.00 and tenant A pays its share of 25% (25,000rsf/100,000rsf) of the $100,000.00, or $25,000.00. Now assume that only 50% of the building is leased. In this case, the janitorial costs will be $50,000.00 and, under the terms of the lease, tenant A will pay its proportionate share of this amount, still 25% (25% of $50,000.00) which is equal to $12,500.00. Assuming the tenants occupying the other 25% of the building pay the same, the landlord is left to pay $25,000.00 of the janitorial costs. Using a gross up clause, the landlord is permitted to extrapolate the janitorial costs to a fully occupied building, thereby requiring tenant A to pay $25,000.00.

d) **Operating Expenses Caps.** On occasion, a landlord and tenant will agree to some form of cap on the amount that the Tenant’s Share of Operating Expenses may increase from year to year. When negotiating a cap, a landlord must be sure to include a sufficient cushion for unanticipated costs. The tenant will want to confirm that the cap is meaningful and acceptable.

- Landlords will resist a cap for the same reasons that landlord’s resist a Gross Lease.
- The cap is an appealing shortcut to focusing on, understanding and negotiating the Operating Expense provision. The cap, however, is different from a Gross Lease in that it does not eliminate the landlord’s burden and cost of administering, accounting for and collecting Operating Expenses.
- Tenants benefit from certainty of business operation cost.
- Even when a cap is agreed to, certain expenses over which the landlord has no control or “uncontrollable expenses,” are usually excepted from the cap (e.g., insurance, real estate taxes, utility costs.)

4. **Billing and Payment Process.**

The process for collecting Operating Expenses typically involves the following;
• Landlord provides the tenant with an estimate of Tenant’s Share of Operating Expenses for the upcoming year. This estimate may be based on the past years data and/or landlord’s projections.

• Tenant pays 1/12 of the estimated amount monthly along with its base rent payment.

• At the end of the operating year, landlord provides tenant with a statement of the actual expenses for the prior year, tenant’s share thereof, the amount that tenant has previously paid in accordance with landlord’s estimate, and the balance owed by tenant. Tenant is then required to pay to total balance due (or landlord to refund the overpayment) within some period of time, often 30 days.

• After receipt of the statement, the tenant often has a period of time in which to voice its objections to the calculation, and to notify the landlord that it intends to conduct an audit or review of the underlying calculations.

5. Audit Rights
Since the tenant is being asked to pay for Operating Expenses, the tenant has a legitimate interest in being able to review the underlying data that the landlord has used in calculating tenant’s share. Many issues are raised in drafting and reviewing an audit right and need to be considered in determining its true value.

• What level of detail is required in the Operating Expense Statement? Is there sufficient line item detail to enable the tenant to determine if an audit is necessary?

• Must the Statements be prepared in a consistent manner?

• How long will the tenant be given in order to notify the landlord of its intent to audit?

• Will the tenant be required to pay the amount in dispute before exercising its audit right?

• Does the landlord have the right to approve the party conducting the audit?

• Does the lease prohibit a tenant from hiring an auditor on a contingency fee basis?

• Is confidentiality required of both the tenant and the auditor before conducting the audit?

• Who pays for the cost of the audit? Does the answer vary depending on the results?

• Where and when must the audit be performed? Where are landlord’s books and records maintained?
• Is there a time limit for how long the audit may take?

• How far back may the audit reach? Does the answer depend on the results of the audit?

• If landlord has overcharged tenant, will tenant be entitled to interest on the amount of overpayment?

• If it is revealed that the tenant was undercharged, can the landlord charge the tenant?

• If the lease is silent on the issue, will an audit right be implied by a court?

III. CONCLUSION.

The parties to a lease typically spend days, and even months, negotiating base rent amounts, and make great efforts to get the best deal, prior to memorializing their understanding in a letter of intent or term sheet. A difference of $1.00 or even 25 cents per square foot takes on a great deal of importance and its impact is easily calculated by the parties to a lease. In the same letter of intent, the issue of rent escalation is usually addressed with a couple of words, “Triple Net;” or in a sentence, “Tenant will pay its proportionate share of increases in Operating Expenses and Real Estate Taxes over the base year.” This makes sense in order to keep the deal moving forward. It is essential, however, when moving into the lease negotiation stage, that the Operating Expense provision be negotiated with at least (if not more) effort, understanding and conviction as were the base rent amounts. A poorly drafted Operating Expense provision could have unexpected results to either party – unexpected results that far exceed any and all concessions made during the base rent negotiation.