Include Five Critical Operating Expense Protections in Your Lease

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If you are like many office tenants, you focus hard on the specific items included and excluded from the definition of “operating expenses” in your lease. And for good reason, because the costs and expenses that are included or excluded can greatly affect the amount of money you will pay as “additional rent” over your lease term.

Often overlooked, however, are five critical protections that have an impact on operating expenses and that, if not included, can affect your bottom line as well.

These protections are:
- Gross-up protections;
- Limits on profits;
- Caps on controllable expenses;
- Recalculation of your proportionate share; and
- Operating expense audit rights.

These five critical protections are not particular to the market you are in, the size of the lease transaction, your creditworthiness, or any other factor. However, every tenant—whether you are a Fortune 500 company leasing 100,000 square feet in New York City or a small, start-up company taking much less space in the same market—can get these protections.

Because these protections benefit you, most often they will not be included in a typical owner’s lease form. Thus, you will need to discuss them yourself with the owner.

I will explain these five critical protections and how you should address them in your lease. I will also give you Model Lease Language for each of these protections that you can adapt and use in your lease.

FIVE CRITICAL PROTECTIONS

❑ Make Owner ‘Gross-Up’ Certain Costs During Base Year

As a building’s occupancy rate rises or falls, certain operating expenses rise and fall, too, depending on the number of occupants in the building. These “occupancy-dependent” operating expenses may include such costs as electricity, garbage removal, and HVAC.

The occupancy fluctuations can lead to big increases and declines in total operating expenses, which are the sum of the occupancy-dependent operating expenses and also nonoccupancy-dependent operating expenses—that is, those that don’t rise and fall with occupancy.

If you have a base year lease (or “modified gross lease”), it is not fair for you to pay a lot more or less, however, just because the building’s occupancy rate changes. You are still getting the same services, no matter how many other spaces are occupied. Grossing-up is a method that can prevent these big variations.

When an owner grosses-up, it determines how much each occupancy-dependent operating expense would be if the building were nearly full—for example, 95 percent full. This evens out the occupancy-dependent operating expenses in base year leases so they don’t fluctuate with changes in the building’s occupancy rate.
If you have a base year lease and are paying your proportionate share of operating expenses over a base year, make sure that, during the base year, the owner grosses-up:

- All occupancy-dependent expenses; and
- The costs of all services and utilities that other tenants are paying separately—such as tenants paying their electric bills directly to their utility company.

If those expenses and costs are grossed-up only after the base year, but not during the base year, you could end up paying a share of huge increases in operating expenses over the base year.

Example: A lease requires you to pay your proportionate share of increases in operating expenses over a base year. If the building were fully occupied, the owner’s annual tenant-related cleaning expenses would be $100,000. But the building’s occupancy rate in the base year falls to 50 percent, so the cost of the owner’s cleaning services for the base year is only $50,000.

The lease requires the owner to gross-up to 95 percent all occupancy-dependent expenses every year after the base year when the building’s occupancy rate falls below 95 percent. If the building is 100 percent occupied during the second year of the lease term, the owner’s cleaning costs will jump to $100,000. You are stuck paying your share of that $50,000 ($100,000 - $50,000) increase in cleaning services.

However, if the owner were required to gross-up such occupancy-dependent cleaning expenses during the base year, cleaning services during the base year would have been $95,000, instead of $50,000. Thus, you would pay your share of only the $5,000 ($100,000 - $95,000) increase in cleaning services in the second lease year.

Clarify in the lease that the owner must gross-up operating expenses in the base year, as well as any year thereafter in which the building is less than 95 percent occupied:

Model Lease Language
If, during any lease year, including, without limitation, the Base Year:

(i) The Building is less than ninety-five percent (95%) occupied; or

(ii) Landlord shall furnish any service to less than ninety five percent (95%) of the Building, whether because another tenant is separately paying for services or utilities furnished to its premises or otherwise,

then Operating Expenses shall be increased by Landlord to reflect ninety-five percent (95%) of the Operating Expenses that would have been reasonably incurred by Landlord had the Building been at least ninety-five percent (95%) occupied and Landlord had furnished such services to at least ninety-five percent (95%) of the Building.

Don’t Let Owner Profit from Operating Expenses
The owner should not make any profit from operating expenses. Therefore, include a clause prohibiting the owner from collecting an amount greater than your fair share of the operating expenses.

Model Lease Language
Landlord agrees that Landlord shall not collect from Tenant an amount greater than Tenant’s Proportionate Share of the Operating Expenses actually paid by Landlord in connection with the operation of the Building and Landlord shall make no profit from Landlord’s collections of Operating Expenses.

Also, limit the collection of operating expenses to owner’s actual and reasonable operating expenses. Finally, try to eliminate any catch-all phrases in the definition of operating expenses that let owners back in additional operating expenses not specifically set out in the lease. Examples of such phrases include: “any other cost or expense of operating or maintaining the Property,” and “expenses paid or incurred by owner for the operation of the Property, including without limitation...”

Limit Controllable Expenses
Try to place an annual cap on increases in operating expenses that the owner can control—such as building personnel salaries, building service contracts, and management fees. Otherwise, these expenses could get out of hand and you could end up having to pay your share of a huge bill.

For instance, add the following language to your lease, but make sure you define “Controllable Expenses” elsewhere in the lease:

Model Lease Language
Tenant shall have no liability for increases in Controllable Expenses of more than $[insert percentage] in the aggregate per annum, on a cumulative basis, over $[insert base year dollar amount].

Recalculate Proportionate Share if Building’s Size Increases
An obvious and fair thing to do is to put a clause in your lease requiring the owner to recalculate and reduce your proportionate share when the rentable area of the building where your space is located increases. The reduction in proportionate share could end up significantly lowering your operating expense bills.
The reduction in your proportionate share should take effect when the owner receives a certificate of occupancy for any new rentable space in the building, or when any tenant occupies such new space for its business purposes, whichever occurs first. If certificates of occupancy are not issued by the municipality or another appropriate government authority in which the space is located, the trigger should be the document or event that legally allows a person or company to occupy the space.

**Model Lease Language**

If the rentable area of the Building shall at any time exceed [insert rentable square footage of building on the lease’s commencement date], Tenant’s Proportionate Share shall be recalculated and reduced by dividing the rentable square feet of the Premises by the new rentable square feet of the Building. Promptly following any such increase in the rentable area of the Building, Landlord and Tenant hereby agree to execute and deliver to each other an amendment to this Lease memorializing the reduction in Tenant’s Proportionate Share.

If the owner is not required to recalculate your proportionate share when the rentable area of the building increases, you may be stuck paying operating expenses using the old proportionate share, unless you want to spend the time and money to litigate the matter in court. In most states, commercial leases are nothing more than contracts, and the parties can negotiate any terms they want, provided those terms don’t violate the law or public policy.

**Get Right to Audit Owner’s Books**

Make sure you include a clause in your lease that gives you the right to audit, review, and challenge the owner’s calculation of operating expenses. That will help keep the owner honest, and it gives you the right to obtain a refund for any overcharges.

Here is a short checklist to run through each time you negotiate for audit rights.

- **Detailed statement.** Require the owner to deliver to you within 30 days to 60 days after the end of each lease year a detailed statement of its actual operating expenses for the prior year. You don’t want the owner to drag its feet in giving you this information, especially because the statement may indicate that the owner overcharged your operating expenses.

**Model Lease Language**

Within [insert #, e.g., thirty (30)] days after the end of each Lease Year, Landlord shall deliver to Tenant a detailed statement setting forth the Operating Expenses actually incurred by Landlord for the prior Lease Year.

- **Get refund of overpayment.** If the statement from the owner shows that the actual operating expenses for the prior year were less than what you paid, the owner should promptly refund your overcharge.

- **Get enough review time.** Make sure the owner gives you enough time to review its statement of operating expenses, so that you can decide whether to challenge it. Typically, if you don’t challenge an owner’s statement within a set period of time, you will be deemed to have accepted it and will lose your right to challenge it. Therefore, try to give yourself at least 90 days to review the owner’s statement and decide whether you want to dispute it.

- **Get access to books.** Require the owner’s books and records to be available to you at reasonable times and at reasonable locations. For instance, if your lease is for space in Florida and the owner’s offices are based in California, it would be a long haul to the West Coast. In fact, that scenario would probably discourage you from exercising your audit right.

- **Get owner to pay your costs.** If the owner has overstated operating expenses by at least some threshold amount—usually between 3 percent and 5 percent—require the owner to pay for your audit costs. Further, if you have enough leverage in the lease negotiations, fight for the right to receive interest on all overcharges.

- **Submit disputes to arbitration.** If you and the owner can’t agree on whether there has been an overcharge or undercharge of operating expenses, get the right to submit the matter to a mutually acceptable arbitrator or mediator.

**Model Lease Language**

If Landlord and Tenant are unable to agree whether an overpayment or underbilling of Operating Expenses has occurred, or on the amount of such overcharge or underbilling, then either Landlord or Tenant may submit the matter to arbitration in accordance with Clause [insert # of arbitration clause] of this Lease.

Ideally, the arbitrator or mediator should have at least 10 years of experience in handling such disputes in the relevant market.

For more information on what to include in an audit clause, see “Get Effective Lease Right to Audit Owner’s Books and Records,” Insiders, March 2005. You can also download this article from the Real Estate section of Vendome Group’s Web site, www.vendomegrp.com.