COMMERCIAL TENANT'S LEASE INSIDER®

The Leading Newsletter Devoted to Helping Retail & Office Tenants Negotiate, Draft & Manage Their Leases

MAY 2018

FEATURE

Operating expenses are often the most overlooked part of a lease. Here's how to avoid unnecessary costs.

Avoid Common Pitfalls When Drafting Operating Expense Clause

While there are many issues to be concerned with when signing a lease for commercial space, tenants often focus on what's typically the most hotly contested provisions—exclusive use and cotenancy. The right to be the only tenant to sell a product in a center, or get the benefit of other stores that create helpful synergy, can boost that tenant's bottom line. But profits can be undercut when a tenant doesn't give equal consideration to another issue, one that can have dire financial consequences: operating expenses.

New York commercial real estate attorneys Robert P. Reichman and Jonathan B. Weiss often represent large tenants that acquire other companies with offices all over the country, and part of the acquisition process is reviewing the leases that the client is inheriting. In the course of this due diligence process, they often see that operating expense provisions in the current leases have been overlooked in a way that puts the tenant at a disadvantage. Here are the key points they suggest tenants pay attention to when negotiating and drafting the operating expense portion of a new lease or an existing one they're renewing.

Understand Concept of 'Costs' and 'Exclusions'

Both operating expense "costs" and "exclusions" can cost tenants money if they're not drafted properly, Reichman warns. It's important for new and experienced tenants to understand exactly what these are. Operating expenses are expenses incurred by the landlord in operating and maintaining the building. Tenants pay these operating expenses in addition to a fixed monthly rent because by occupying the building, they use and benefit from the services, equipment, and maintenance of the building, Reichman explains. Essentially, operating expenses cover the landlord's expenses of providing the building's operation, which includes items like elevators and heating, ventilating, and air conditioning (HVAC), that are subject to wear and tear or breakdowns that require upgrades and maintenance. "It's completely

(continued on p. 2)

IN THIS ISSUE

Operating Expense Clause

(continued from p. 1)

reasonable for tenants to pay a proportionate share of these for the building," Reichman notes.

The type of lease—"net" or "gross"—the tenant has will make a difference in the way that operating expenses affect its finances. So tenants should understand how these lease distinctions work.

Net leases. In net leases, the rent is net of operating expenses to the landlord and tenants pay their proportionate share of all the operating expenses and insurance and taxes of the building. Tenants pay the expenses without a base year.

Gross leases. In gross leases, the operating expenses for the first year of the lease are included in rent. "That's called a base year," Reichman notes, "and the tenant only pays the increase from the base year in the building's operating expenses." In proportion, the tenant pays its increase; this is not intended to be a profit center for the landlord, he adds. It's simply the reimbursement of actual expenses the landlord incurs in operating the building.

A tenant that wants its lease to provide that operating expenses are intended to reimburse the landlord only for its actual expenses needs to carefully draft this portion of the lease. The language should make sure that the operating expenses charged to the tenant don't exceed the actual costs of operating the building; if you don't have that language, landlords have ways of adding in costs that a tenant wouldn't otherwise be obligated to pay, says Reichman.

(continued on p. 3)

Editor: Elizabeth Purcell, J.D. **Executive Editor:** Heather L. Stone **Director of Marketing:** Peggy Mullaney

COMMERCIAL TENANT'S LEASE INSIDER [ISSN 1551-2215 (PRINT), 1938-3150 (ONLINE)] is published by Vendome Group, LLC, 237 West 35th St., 16th Fl., New York, NY 10001.

Volume 14, Issue 9

SUBSCRIPTIONS/CUSTOMER SERVICE: To subscribe or for assistance with your subscription, call 1-800-519-3692 or go to our website, *www.CommercialTenantsLeaseInsider.com*. Subscription rate: $367 for 12 issues. **TO CONTACT THE EDITOR:** Email: *epurcell@vendomegrp.com*. Call: Elizabeth Purcell at (212) 812-8434. Fax: (212) 228-1308. **TO PLACE AN ADVERTISEMENT:** Please contact Heather Stone at *hstone@vendomegrp.com* or call (212) 812-8436.

Operating Expense Clause
(continued from p. 2)

Make Consistency Count

Tenants should also draft language providing that operating expenses in a gross lease are consistent from year to year. In other words, operating expenses in the base year have to match up with those in each subsequent year. They will increase to some degree, but tenants should make sure that 25 items in the operating expenses statement in Year 1 of the lease are the same 25 items in Year 7 of the lease. Without that consistency, the landlord could add new expenses. It would result in a tenant being required to pay 100 percent of those new expenses—rather than just the increase, Reichman stresses.

For example, flowers added as a new line item that weren't in the base year could become expensive. In a carefully drafted provision, the flowers missing from the base year and added in a subsequent year couldn't be charged fully to the tenant. If that protection isn't in the lease, the tenant could be on the hook, hoping that the landlord might, at best, split the difference. "If a landlord is adding a new service, that's not an increase in cost, it's an entirely new service—to which the tenant can rightfully object, if it has negotiated that right and drafted lease language to that effect," he says.

Consider Cost-Saving Exclusions

Reichman and Weiss have seen many tenants negotiate as few as 10 and as many as 60 exclusions from operating expenses, depending on their leverage and negotiating power. Two major exclusions that every tenant should talk with their attorney about are:

Exclusion #1: Repairs that result from a fire, hurricane, or similar casualty. Tenants should try to exclude the cost of repairs that would otherwise be covered by insurance. For example, in case of a fire, the landlord's all-risk policy should cover repairs and tenants should pay nothing. However, Weiss points out that landlords always want to pass through the insurance deductible for casualties to tenants. Unfortunately, casualty policy insurance deductibles can be high. If a tenant leases 50 percent of the building's space, it'll be responsible for a $1.5 million deductible on a $3 million policy. The goal for tenants is to limit the amount of the deductible and exclude repairs caused by fire or hurricane whether or not they are covered by insurance. Otherwise, if the landlord is permitted to include the entire or a large portion of the deductible, the tenant is in essence allowing the landlord to charge it for capital repairs.

Exclusion #2: Capital improvements. Tenants should be responsible only for ongoing maintenance and repair at a property; they shouldn't be obligated to pay for things that increase the value of the building, says Weiss, who recommends excluding capital items in the lease. There are two concessions that tenants will often agree to that permit the landlord to include capital improvements in operating expenses.

- **Capital improvements required by law.** One concession is a capital improvement required by law that comes into effect after the date of the lease. For all other improvements, the landlord should already know what laws

(continued on p. 4)

Operating Expense Clause

(continued from p. 3)

are in effect and what improvements are required and so those should be included in rent.

- **Capital improvements that reduce operating expenses.** The second concession is a capital improvement that isn't required by law but that has the effect of reducing operating expenses that the tenant pays for the building. The tenant gets a benefit from this type of capital improvement, says Weiss, so it's reasonable for the landlord to pass the cost on to a tenant. For example, a capital improvement to upgrade the HVAC system that reduces energy usage would be reasonable, whereas installing Italian marble in the building's lobby would not, because it has no cost savings for a tenant. In either case, the nature of the capital item could be a significant expense, and if a tenant leases a significant portion of a building, it would want to avoid having too many capital improvements passed through all in one year, Weiss notes. He points out that although the landlord should amortize the cost of a capital improvement over its "useful life," there is sometimes a struggle between a landlord that wants a shorter amortization period and a tenant that wants the longest amortization period possible. When amortization is done in a tenant-favorable way, the tenant should pay only its share of that expense during the term of its lease.

For cost-saving capital improvements tenants should permit the landlord to include amortization only up until the cost of the actual savings. If the lease includes more than the landlord has saved, the landlord is getting more than it should under the standard tenant amortization schedule, Weiss says. While lease language can cap these cost-saving capital improvements, it's key for tenants to be able to prove the amount of the cost savings. Tenants should require the landlord to prove the savings and have a third party verify this. For example, the landlord should provide proof of fuel costs before and after an upgrade. That substantiates the landlord's cost.

"Generally speaking, a good plan for tenants is to limit capital improvements to these two categories and make the landlord prove that upgrades not required by law actually resulted in savings—otherwise the landlord can pass through basically anything," Weiss suggests. "The tenant should pay for ongoing maintenance, not underwrite expenses that add value to the building to attract other tenants," he emphasizes.

Protect Bottom Line with Audit Rights

To enforce operating expense exclusions, a tenant should negotiate audit rights. Tenants typically get an operating statement at the beginning of the year with estimated costs, and a reconciliation at the end of the year. However, these aren't tailored to a tenant's specific lease. The landlord gives the same annual statement to every tenant and line items aren't specific to each tenant. So without having enforcement rights in the lease, the exclusions are meaningless. Getting the right to audit and review the landlord's books and records to make sure that

(continued on p. 5)

Operating Expense Clause

(continued from p. 4)

the operating costs are consistent with what you've negotiated in your lease and are obligated to pay for is crucial, say Weiss and Reichman.

"Because the same line items are in every statement, most tenants don't look, although it's up to the tenant who has the audit rights to challenge things," says Weiss. The landlord can't possibly tailor every operating expense statement to each tenant, so it puts the onus on the tenant to come up with the right result. But many tenants just get the statement and pay it, he notes. It's in the tenant's best interest to look closely at statements; if the tenant has audit rights and is overcharged, it would get the costs of the audit back and interest on the overcharges.

Tenants should be prepared for pushback from an owner that will try to limit audit rights, usually by putting a very short limit on the time during which the tenant has to contest charges. Generally, the tenant will get an operating statement and 60 days to complete an audit and contest overcharges. However, 60 days isn't enough time for large tenants. And many landlords won't agree to any kind of alternate dispute resolution. Using an audit company is one compromise, although some landlords will prohibit tenants from hiring an audit firm that works on a contingency fee basis.

Tenants should also try to include a reasonable time limit, say one year, during which the landlord can make corrections to its operating expense statement. This is especially important in cases where there could be a change of ownership; a new owner might be more aggressive in collecting operating expenses that had been forgotten. Saying that both sides should be limited in the time they can go back to correct mistakes protects both sides.

Although tenants should look at all items in the operating expenses statement, there are some items to watch out for that commonly cause issues, such as parking. If the landlord is charging a monthly fee for parking, the parking garage shouldn't be included in monthly operating expenses. If the landlord has a separate charge for parking then only the operating cost and expenses that exceed the revenue for the parking operation should be included in operating costs. The rest should be excluded.

And every building has a management fee, whether the management is landlord affiliated or through a third-party company, and that can get tricky. Usually, landlord-affiliated management companies charge a fee based on square footage, while third-party company fees are based on revenue. Management fees that are 3 percent of the building's revenue can be expensive, so make sure to exclude from the definition of total revenues overtime HVAC, rooftop charges, and parking charges.

"Most importantly, as far as management fees in a gross lease are concerned, the tenant wants to make sure that any rent abatements or another tenant's free rent, for purposes of a management fee, are disregarded," says Reichman. Otherwise, a management fee based on revenue from the building will be lower during the period of rent abatement, but when that expires and the other tenant starts pay-

(continued on p. 6)

Operating Expense Clause

(continued from p. 5)

ing rent in the second, third, or fourth year of the lease, the original tenant's fee will go up. In other words, in the base year, have the landlord determine revenue without taking into account rent abatements.

PRACTICAL POINTER: The type of mistake a landlord makes in an operating expense statement—whether that's a mistake in the arithmetic or the inclusion of items that aren't permissible—doesn't affect a cut-off time frame to audit. A contest over any issues would have to be in the time frame spelled out in the lease. ♦

Further information: For more on operating expense clauses and other commonly overlooked lease provisions, you can download the on-demand webinar presented by Reichman and Weiss, "Beyond the Basics: The Top Overlooked Lease Issues," at *www.nycla.org/ItemDetail?iProductCode=CLE_OD_BESTPR4.*

Insider Sources

Robert P. Reichman, Esq.: Wilk Auslander LLP, 1515 Broadway, New York, NY 10036; *www.wilkauslander.com.*

Jonathan B. Weiss, Esq.: Wilk Auslander LLP, 1515 Broadway, New York, NY 10036; *www.wilkauslander.com.*

RECENT COURT RULINGS

➤ Trial Necessary to Determine Whether Cotenancy Clause Constituted 'Liquidated Damages'

FACTS: A clothing retailer tenant signed a lease for space at a shopping center. The lease included cotenancy provisions that required the owner to lease space to three major tenants. If all three tenants were open and operating continuously, the retail tenant paid minimum rent. In the event that one or more of those tenants stopped operating, the retail tenant could pay reduced rent and it would be considered a breach of the lease. One of the tenants moved out of its space before the expiration of its lease. The owner found a replacement tenant before the retail tenant could begin paying reduced rent. When the replacement tenant moved out of its space, the retail tenant invoked the cotenancy provisions. The owner argued that the departure of the required tenant didn't trigger the cotenancy clause because the remaining required tenants still brought foot traffic to the center and the retail tenant's profits didn't decrease. According to the owner, the fact that the retail tenant didn't suffer any economic harm would effectively make the cotenancy provisions "liquidated damages" that were punitive, and not provide the intended result of compensating the retail tenant for its actual damages. Instead, the owner would lose a significant amount of money that was not commensurate with damages.

The retail tenant continued to pay minimum rent "under protest," and asked a trial court to enforce the provisions. The owner sued the tenant, asking the trial court for a judgment in its favor and to order the tenant to pay minimum rent.

(continued on p. 7)

Recent Court Rulings

(continued from p. 6)

DECISION: A Nevada trial court concluded that a trial was necessary.

REASONING: In explaining its decision, the court noted that, although it might be true that the departure of the tenant and the replacement tenant didn't economically harm the retail tenant, the owner and retail tenant were sophisticated parties that had negotiated the lease at "arm's length" with their attorneys and that the owner shouldn't now try to get out of the provisions it agreed to—that the retail tenant could pay reduced rent rather than minimum rent until a suitable tenant was open and operating in the now-vacant space.

It also addressed the owner's argument that reduced rent would drastically harm the owner and would therefore qualify as liquidated damages that were designed to be punitive and, therefore, would be unenforceable. The trial court noted that liquated damages were an issue that couldn't be determined by a judge. Rather, a jury trial was necessary. ♦

- Boca Park Marketplace Syndications Grp., LLC v. Ross Dress for Less, Inc., March 2018

NEGOTIATING TIPS

Make Six Modifications to Owner's Rent Acceleration Clause

Aside from termination rights, rent acceleration clauses are considered by tenants to be one of the harshest measures an owner has at its disposal as a remedy for nonpayment. This type of clause allows the owner to "accelerate" the rent due if you default. Essentially, a rent acceleration clause will force you to pay the rent for the rest of your lease immediately.

Ideally, you'll want to leave out a rent acceleration clause from your lease. But expect some pushback. That's because rent acceleration clauses give owners protection against defaulting tenants. So you may have a hard time, even if you're a strong or large tenant with a lot of leverage, eliminating this provision from your lease entirely. But an owner might recognize that a compromise version can still fairly compensate it for losses if you default, so suggest a middle ground. Here are six modifications you can make to get a toned-downed version of the owner's suggested rent acceleration clause.

Ask for Compromise on Key Points

To make the rent acceleration clause that you negotiate with the owner of space you are planning to lease fairer to you, make sure that, like our *Model Lease Clause: Negotiate Middle Ground with Owner on Rent Acceleration,* the clause you negotiate does the following:

Point #1: Limits acceleration to monetary defaults. Only monetary defaults—such as unpaid monthly rent—should trigger the acceleration clause. You can

(continued on p. 8)

Negotiating Tips

(continued from p. 7)

argue that the owner shouldn't have the right to accelerate the rent for any other type of lease default. It's too harsh a remedy for a nonmonetary default [Clause, par. a]. But be prepared for the owner to respond that any default serious enough to let it terminate the lease should also let it accelerate the rent.

Point #2: Excludes additional rent. Traditionally, leases have provided for acceleration of additional rent as well as fixed rent. But in today's leasing environment, you should try to limit acceleration to the fixed rent only. You have a strong argument for excluding additional rent, such as common area charges and tax and insurance payments that are pass-throughs under the lease. That's because if the common area, tax, and insurance charges are pass-throughs—as is common in shopping center leases—they'll be covered in the next tenant's lease [Clause, par. b].

This same logic applies if you're a percentage rent tenant—that is, you shouldn't have to pay accelerated percentage rent because the next tenant will also have a percentage rent lease. Plus, you could argue that a default is more likely if your sales are low—which means the percentage rent you'd owe would also be low or nonexistent.

In a shopping center lease, the owner may give in to a strong tenant on this point. In an office lease, where additional rent is paid in the form of escalations rather than pass-throughs, the owner will often insist on accelerating additional rent along with fixed rent.

Be aware that if you agree to accelerate additional rent along with fixed rent, the owner may use past additional rent to estimate the additional rent to be accelerated. A more aggressive owner may take the additional rent paid in the 12-month period preceding your default and increase it by a fixed percentage for each remaining year of the lease term. Its argument is that doing so will cover expected increases in pass-throughs and escalations. Try to resist such increases as speculative.

Point #3: Deducts rental value of space. An owner can relet space once a defaulting tenant has moved out. That could give an owner a windfall if the owner also collects accelerated rent from a tenant equal to the tenant's full rent through the end of the lease. To avoid giving the owner such a windfall, reduce the accelerated rent by deducting the "fair rental value" of the space for the period from when rent is accelerated to the end of the lease [Clause, par. b].

Deducting the fair rental value makes the acceleration clause fairer for you. It gives you a credit for what the owner should receive if the space is re-rented at fair rental value. Thus, it more accurately reflects the damages the owner suffered as a result of your default.

In today's market, an owner may argue that it will be shortchanged on rent if there's a lengthy "downtime" until it can relet the space. But in some states, owners are required to mitigate their damages. That is, the owner may not be allowed to collect accelerated rent until it has shown that it has used reasonable

(continued on p. 9)

Negotiating Tips

(continued from p. 8)

efforts to reduce its damages by, say, reletting the space—if it's allowed to collect accelerated rent at all.

Point #4: Defines fair rental value. The term "fair rental value" is rarely defined in an acceleration clause. So if you can get the owner to agree to deduct fair rental value from the accelerated rent, you'll want to define that term so that the amount is both predictable and as high as possible. For example, you may want the clause to say that fair rental value is to be determined on the basis of rents for comparable space nearby and on the assumption that the value will be determined with reference to the maximum economic utilization of the space [Clause, par. b].

The owner, on the other hand, will want to keep the fair rental value down. It may prefer to define it as "net fair rental value, reducing the fair rental value by the cost of "customary tenant concessions." (Customary tenant concessions would include things such as rent concessions, construction allowances, and work letters.)

(continued on p. 10)

MODEL LEASE CLAUSE

Negotiate Middle Ground with Owner on Rent Acceleration

Remember that you shouldn't agree to compensate an owner for more than its losses. This fair rent acceleration clause, will allow an owner to accelerate your rent upon a monetary default, but keeps that sum from being unreasonably large. The clause also allows the owner to collect accelerated rent—but subtracts the space's fair rental value and discounts the accelerated rent at an agreed-upon interest rate to reflect its present value. Show this clause to your attorney before using it for your leases.

RENT ACCELERATION

a. Acceleration required. If Tenant commits a monetary default, Landlord may, at its option, any time after this Lease is terminated pursuant to Article [*insert #*] above, upon [*insert #*] days' prior written notice to Tenant, require Tenant to pay Landlord the Accelerated Rent, discounted to present value as hereinafter provided.

b. Amount due. The Accelerated Rent shall be an amount equal to the Minimum Rent (not including Additional Rent or Percentage Rent) payable over the balance of the term of this Lease (as if this Lease had not be terminated) less the fair rental value of the Premises for the corresponding period. Fair rental value is to be determined on the basis of rents for comparable space nearby and on the assumption that said value will be determined with reference to the maximum economic utilization of the Premises.

c. Discount. The Accelerated Rent shall be discounted to the date payable at an annual interest rate equal to [*insert either a fixed percentage or a rate tied to an index*].

d. Release. Upon payment of the Accelerated Rent pursuant to this Clause, Tenant shall be released from all further liability under this Lease except for any accrued and outstanding obligations.

Negotiating Tips

(continued from p. 9)

Unfortunately, the owner may also want the clause to say that if the space is relet before the accelerated rent is finally determined (by a court or otherwise), the rent under the new lease will be considered the fair rental value. But he cautions that a new lease's rent may be lower than the going rate—especially if the new tenant is related to the owner.

Point #5: Calculates present value of accelerated rent. Money paid up front is worth more than the same sum over a period of time. So say in the lease that if you must pay accelerated rent, the amount should be "discounted"—that is, reduced to reflect the present value of the future accelerated rent payments. To calculate the present value of the accelerated rent, an appropriate interest rate, or "discount rate," is needed. The lease clause should specify the discount rate or at least specify how you'll determine it.

Of course, you'll negotiate for a high discount rate and the owner for a low one. A high rate will reduce the amount of accelerated rent far more than a low rate. There are two options: (1) a fixed rate agreed upon by you and the owner; or (2) a rate tied to an index. Because a rate that's fixed when the lease is signed may be out of line with interest rates at the time of a default, many tenants prefer a rate that's pegged to an index. You would do well to negotiate for a discount rate tied to an index that measures commercial rates of return (such as a designated bank's prime rate) [Clause, par. c]. An owner might demand a discount rate pegged to a conservative, safe investment with a relatively low rate of return.

Point #6: Limits your lease obligations. Make sure that the acceleration clause limits your lease obligations. That is, say that you don't want to have any further liability under the lease once you've paid accelerated rent plus whatever you owed before the rent acceleration [Clause, par. d]. Don't be surprised if a smart owner also demands that you pay any costs it incurs because of your default. For instance, it may want legal fees and reletting costs. ♦