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Operating Expenses Provisions

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OPERATING EXPENSE PROVISIONS

I. INTRODUCTION

A common area of negotiation in commercial leases are the provisions outlining allowable operating expenses that a Landlord is allowed to charge the Tenant, as well as certain costs which a Landlord cannot seek to re-coup from a Tenant. Since Operating Expenses can account for up to ½ of the base rental charged for certain Class A Buildings, Operating Expense inclusions and exclusions can lead to significant costs or savings for both Landlords and Tenants. This article will highlight market inclusions and exclusions for Operating Expenses pertaining to all asset classes, as well as related landlord billing and audit mechanics. Sample provisions for standard inclusions and exclusions are included in Exhibit A and Exhibit B to this article, respectively. While no definitive case law touches on the foregoing, the understanding of “market” provisions and implementation of related safeguards can allow counsel to nonetheless represent their clients’ interests effectively.

II. MARKET OPERATING EXPENSE INCLUSIONS

Whether representing a Landlord or Tenant, counsel will often have to negotiate the types of standard Operating Expenses that flow through to a Tenant. While many of these items can be fairly ubiquitous (e.g., utilities, wages of certain employees, capital investment items, etc.), buildings will often have unique characteristics and costs which a Landlord wants to pass through to the Tenant and require particular drafting from counsel. For example, perhaps the Landlord wants to pass-through certain expenses with respect to maintaining a building’s LEED status, which in-turn can lead to energy savings to each tenant in the building. Or a particular building might have certain amenities (e.g., conference centers, work-out rooms, etc.), the costs of which a Landlord might want to pass through since they benefit each tenant in the building. In addition to particular Operating Expenses, counsel will want to be cognizant of certain “market” limitations, such as property management fees being limited to approximately 3% of gross revenue or limiting the number of square feet a landlord can attribute to a property management office. Ultimately, a Landlord’s counsel will need to confer with their client (and, preferably, property management as well) to have an intimate knowledge of the Building’s operation and understand what particular Operating Expenses will need to be reflected in the lease form. This knowledge is invaluable in drafting an appropriate lease form and for explaining to Tenant’s counsel during leases

negotiations. While there is no universally accepted list of Operating Expense inclusions, attached as Exhibit A are common “market” inclusions which are often seen in commercial leases.

III. MARKET OPERATING EXPENSE EXCLUSIONS

An important companion to Operating Expense inclusions are the Operating Expenses which a Landlord is explicitly prevented from passing through to a Tenant under the Lease. Clearly defined exclusions are important to ensure that Operating Expense inclusions are limited and jointly agreed upon. Like Operating Expense inclusions, some Operating Expense exclusions are fairly standard and accepted (e.g., costs of art, political contributions) while others are subject to interpretation and negotiation. For instance, if a Landlord is attempting to pass-through Operating Expenses for a particular Building amenity, is that amenity generally accessible to all tenants in the Building? While Tenant’s counsel should always either request an expanded list of Operating Expense exclusions or provide specific additional and/or revised exclusions during lease negotiations, the Landlord side of the equation can be more complex. As Landlord’s counsel, do you have a standard list of expanded Operating Expense exclusions (preferably with input from your client and/or their property manager) which you can easily provide to a requesting Tenant? Or, do you have the luxury or working with a sophisticated client and property management team that can negotiate inclusions/exclusions on an ad hoc basis based on experience and practice? On the Tenant side, what is the client’s sensitivity to the issue? Does the client simply want to ask for a broader set of Operating Exclusions and move on or is the client taking a substantial amount of space and thus more sensitive to these costs? While there is no universally accepted list of Operating Expense exclusions, attached as Exhibit B are common “market” exclusions which are often seen in commercial leases. In addition, Tenant’s counsel should actively seek guidance from Tenant’s broker who will typically have a list of their favorite Operating Expense Exclusions (sometimes tailored to the particular building).

IV. OPERATING EXPENSE BILLING

All commercial leases have a section dealing with how Operating Expenses are administered to tenants. Many leases will allow the Landlord to forecast Operating Expenses for the year in question, provide a statement of such expenses to the tenant and have the Tenant pay such expenses in equal monthly installments throughout the year. However, Operating Expenses are subject to change throughout any given year or even month. Accordingly, Landlords must be given the freedom to reconcile expenses throughout the year and ultimately at the end of the year.

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