

Five Ways to Limit Your Liability for Operating Expenses

By Alan M. Cohen, Esq.

Most commercial leases that require payment by the tenant of its share of the building's operating expenses include a lengthy definition of the term "operating expenses." The definition typically includes a laundry list of potential and actual expenses for which the tenant will be responsible. While many landlords are willing to exclude certain limited items from operating expenses, they typically have little patience when discussing operating expense exclusions. Most commercial tenants are left with an overly broad definition of operating expenses and a narrow list of exclusions.

A tenant's liability for operating expenses might approach or even exceed its liability for base rent, yet unlike base rent, operating expenses are rarely fixed or tied to a formula that provides any degree of certainty. Rather, operating expenses are outside the control of the tenant, and in many cases, rather unpredictable.

During the letter of intent stage, there are certain concepts tenants should include to obtain certainty regarding operating expenses—such as expense stops or caps on controllable operating expenses. It's worth discussing these concepts with your attorney. But it's crucial to also familiarize yourself with the following five concepts all tenants should include in their leases to protect against runaway operating expenses regardless of their ability to obtain other protections such as expense stops, caps on controllable operating expenses, and recommended exclusions from the definition of "operating expenses."

Require Landlord to Take Advantage of Any Available Discounts

Many large commercial landlords have considerable purchasing power with respect to materials and services purchased for their buildings. Most vendors gladly will sell to large commercial landlords at a reduced price to gain repeat business. Discounts may be available to smaller landlords also. Landlords should not be required to go to Herculean efforts to obtain discounts, but they should be required to take advantage of all discounts available to them in the marketplace.

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Include language in your lease requiring the landlord to take advantage of any available discounts. It is doubtful a court would find a landlord in breach for choosing a higher priced option where the landlord had a reasonable basis for doing so, but language requiring the landlord to take advantage of discounts will encourage the landlord to be a cost-conscious consumer. Because landlords typically pass along operating expenses to their tenants, many commercial landlords lack incentive to maintain low operating expenses. This is particularly true for landlords with high-demand properties. Lease language requiring the landlord to take advantage of available discounts should cause a landlord to think twice before spending money it does not need to spend on operating expenses.

Get the Benefit of Any Discounts Landlord Receives

It is not enough to require landlords to take advantage of discounts; landlords also should be required to pass along those discounts to their tenants.

Discounts can take many different forms. A landlord may receive a percentage discount for each dollar spent, an annual or quarterly credit or rebate based on purchases during the prior period, or free goods or services.

Some landlords may have master service or supply agreements covering multiple properties that do not provide for discounts on a property-by-property basis, but rather based on all purchases under the master agreement. Discounts landlords receive under a master agreement may not appear in operating expense accounting for a specific property, but if a discount is based on aggregate purchasing, the discount should be reflected on the accounting for each property for which it is based, and passed along to the tenants. Thus, if the landlord receives a 10 percent rebate toward janitorial services incurred for the prior year for all of landlord's buildings, you should receive a 10 percent discount on the amounts you owe for janitorial services for the prior year.

Although enforcement of this requirement could prove difficult, particularly if discounts are paid through free goods and services, including the requirement in a lease could prove beneficial in the event of an operating expense audit.

State that Landlord Cannot Collect More Than It Spends

Operating expense provisions are intended to reimburse landlords for actual expenses incurred in building operation and management. Landlords should not be allowed to collect more than they spend on operating expenses or to profit from lease provisions requiring payment by tenants of operating expenses. Most operating expense provisions provide for payment of a management fee to the landlord equal to a percentage of total operating expenses incurred. The management fee is the only income a landlord should receive on account of operating expenses.

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Landlords should not be permitted to arbitrarily add profit and overhead to invoices supplied by their suppliers and service providers. Lease language that prohibits a landlord from recovering through operating expense reimbursement more than it spends also serves to state the obvious: A landlord should recover payment for only those goods and services actually supplied. Landlords should not receive a windfall through operating expense reimbursement, and tenants should attempt to include language recognizing this principle in their leases.

Deny Expenses Arising from Landlord's Imprudent Management

When a tenant agrees to reimburse a landlord for expenses the landlord incurs in the building's operation and management, the tenant assumes the landlord will act as a prudent and responsible building manager. Imprudent building management can cause operating expenses to skyrocket. Mismanagement might cause a building and its systems to fall into disrepair, leading to increased maintenance costs, the need for capital improvements, and higher utility costs. An irresponsible manager might hire disreputable service providers who bill too much for their work, do not complete their work, or perform negligent work that must be corrected.

Accordingly, it is important to include lease language that makes it clear that operating expenses arising from imprudent management by the landlord or the building manager it hires are not to be passed along to the tenants. Language that prevents a landlord from collecting expenses arising from its imprudent management will reduce the tenant's exposure for operating expenses arising from the landlord's negligence, and will promote prudent management.

Don't Pay Penalties and Interest Resulting from Landlord's Late Payment

Most vendors, suppliers, and service providers charge penalties and/or interest in the event of late payment. The same is true for providers of utilities and taxing authorities. If a landlord does not pay the building's bills on time, the amounts due will increase. If a lease does not include language relieving the tenant of responsibility for penalties and interest resulting from landlord's late payment, the landlord may attempt to pass the penalties and interest resulting from its late payment on to the tenant. Late payment by a landlord may result from mere negligence by the landlord, or it may be the result of cash flow problems.

If a landlord cannot pay its bills on time because of a tenant's failure to pay in accordance with the requirements of the lease, it is understandable that the tenant would be responsible for the consequences of late payment. However, if a landlord's late payment cannot be attributed to the tenant, then the tenant should not be financially responsible for more than its proportion-

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ate share of the original bill. Language that makes it clear that the tenant is not responsible for the financial consequences of the landlord's late payment protects the tenant against the financial consequences of the landlord's delinquency.

Key Point to Remember

A landlord should never recover a windfall or even supplemental income through operating expense reimbursement, and a tenant should never be required to pay for its landlord's inefficiencies or imprudent management of the building. Regardless of whether a tenant is able to negotiate a favorable expense stop, a cap on controllable operating expenses, or an acceptable definition of operating expenses, the above concepts should be included in every lease to limit your responsibility for operating expenses. The following lease language can protect your interests when it comes to operating expenses. Ask your attorney before using it in your lease.

Model Lease Language

Landlord shall make payments for goods, utilities, and services in a timely manner to obtain the maximum possible discount. Operating Expenses shall be reduced by all cash discounts, trade discounts, or quantity discounts received by Landlord or Landlord's managing agent in the purchase of any goods, utilities, or services in connection with the operation of the Building. Landlord shall not collect in excess of one hundred percent (100%) of all Landlord's Operating Expenses. There shall not be included in Landlord's Operating Expenses any costs in excess of those that would be reasonably incurred by prudent operators and managers of similar first-class buildings. There shall not be included in Landlord's Operating Expenses any fines, penalties, and interest resulting from late payment by Landlord. ♦

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