

OPERATING COSTS

Operating costs are an unavoidable component in many leasing transactions. The financial impact of these clauses is substantial, both for tenants and for lessors. This is the first in a series of articles on this critical element of a lease.

I will begin this article with a very simple piece of advice: whether you are a tenant or a lessor, read your lease! And above all, read the clause on operating costs very attentively. Put questions to your advisers, and discuss this with them. In short, make sure that what you are signing truly reflects what you intend. Because operating costs are a major and essential component of a commercial lease, it is essential to have a good understanding of them and to be sure they are written correctly. As the writer Alberto Manguel has stated, "reading is writing's apotheosis."

In these tough economic times for lessors, all income generated by leases is of key importance, and all spending for tenants is also a vital matter. But a commercial lease is a contract with particularities that can sometimes be surprising for tenants. For many companies, for which the lease is the largest expense after employees' salaries, it should be expected that these financial obligations be set out clearly. Unfortunately, this is not always the case; for example, for many office tenants who become involved in this type of contract only once every five or ten years, the full subtleties of the recovery of operating costs are sometimes ambiguous and hard to make out clearly. It must be understood that operating costs, which account for a substantial portion of the financial obligations in a lease, quite often are not clearly foreseeable and are subject to the text of the lease. Nor should it be forgotten that the goal sought by a lessor is to ensure the financial transfer of this expense burden to tenants. This transfer varies by building, by market or sometimes even by tenant. There thus exists no fully precise standard. The only reference guide

remains the operating cost clause contained in the lease. A sensible tenant will benefit by getting sound advice so as to prevent any surprises. The lessor, meanwhile, has an interest in ensuring that the text of his lease reflects his financial objectives.

A rather surprising example of abuse by a lessor has been reported in the United States. The lessor had decided to apply the "gross up" clause as a way of increasing all operating charges. As we know, this clause can be used only in cases where operating costs vary with occupation, such as cleaning costs in an office building. By means of some clever calculations, completely contrary to the terms of the leases in place, however, operating costs had miraculously risen quite substantially. What is most interesting (and most disturbing) is that none of the tenants understood what had been done, and they all meekly paid their monthly rents. It took intervention by the attorneys of a more vigilant tenant, in connection with a lease audit, for this unfortunate ploy to be noticed and corrected. Some tenants learned to their expense that it is better to follow up the expenses incurred.

Some authors have attempted to define the distinctions between a gross lease, a net lease, a net net lease and a net net net lease. The distinction lies essentially in the type of expense that can be recovered from the tenant, meaning operating costs in particular. A gross lease is a lease under which the lessor agrees with the tenant on a predetermined rent with no possibility of recovering other expenses. A net lease is a lease under which the parties agree on a minimum rent and on reimbursement of some other expenses as agreed to between the parties. A lease referred to as net net or net net net has



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little effect, for all intents and purposes, on the parties' rights and obligations, with the important thing being to determine the extent of the rights and obligations contained in the lease. These authors have established certain guidelines with respect to these notions, but the jurisprudence has concluded, advisedly, that the text in the lease is what really matters in determining the type of expenses or taxes that may or may not be invoiced to the tenant. Accordingly, content prevails over form.

lessor. We cannot forget that the financial worth of a building is determined by the financial value of its leases. The net rent generally is set out clearly. However, operating costs can be a different matter. Mistakes in the writing of the operating cost clause will necessarily have an impact on a building's worth. The result is an obvious dichotomy between the lessor's and the tenant's interests. The tenant will

always be concerned with his occupation cost and his interest in limiting some expenses that can be invoiced to him without him having really consented to that type of spending. Meanwhile, the lessor will always be concerned with the yield and worth of his investment. A lease is a contractual document in which the obligations of each party are usually quite clear. However, the operating cost

COMPONENTS OF RENT

In the context of a net commercial lease, added rent represents the amounts payable by the tenant aimed at reimbursing the lessor for operating costs and for taxes imposed on a building. This component is basic to the very essence of a net lease. What this generally includes are reimbursement of property taxes, insurance, maintenance costs, repairs, administrative and management costs, and heating, air conditioning and ventilation costs, as well as any other expenses related to exploiting and operating the building.

To have a clear understanding of the context of operating costs in a commercial lease, it is useful to understand all the rent components in a lease. In a net lease, the two following notions may generally be found: Basic rent; Additional rent.

Each of these two notions is essential and consists of several elements.

Basic rent usually consists of the following elements: the effective net rent, which in a way constitutes the profit made by the lessor, and what I would call the other components of basic rent, which include the amortization of various elements, in particular the cost of work conducted by the lessor, free rent, monetary allocations to the tenant, broker's commissions, any lease takeover, all moving costs, etc. This list is not comprehensive and varies from one transaction to another. In calculating the financial establishment of a lease's yield, all these expenses are taken into consideration.

ADDITIONAL RENT CONSISTS ESSENTIALLY OF OPERATING COSTS AND TAXES.

Operating costs, like rent in general, represent a substantial amount for the

component remains an element that can leave room for interpretation, which is not always precise as regards the parties' true financial obligations. It follows that the tenant may encounter some nasty surprises and may face an unexpected situation. The goal of the parties is thus to ensure that these terms are sufficiently clear and that the agreement between the parties contains sufficient limitations.

_THE IMPORTANCE OF A CLEAR TEXT

This leads us to address the importance of the writing of the operating costs clause, which has a fundamental role. Any deficiency in writing will have an impact on the expenses that can be recovered from tenants. Any overly broad or abusive drafting will have a harmful impact on tenants. Moreover, there is a need to be cautious in the use of excessively broad writing in certain respects. For example, an overly detailed listing could have the effect of restricting the application of certain expenses that may not have been described specifically in an extended list; in contrast, a more general description may have a broader positive impact on the recovery of certain expenses to the lessor's benefit. It is all a matter of drafting and of judgment in the terms used and in the goal that is sought either by the tenant or by the lessor.

While the text ought to have certain clarity, it is essential that the parties take the time to know what it contains and to read it before signing it! In *N.R.S.*

Industries Ltd. v. Pham, ruling EYB 2005-97012, the Court took the position that the tenant's failure to examine the lease properly before signing it constituted an inexcusable error considering that the file involved an experienced businessman. The Court also ruled that there had been a lack of evidence that the lessor had failed in his obligation in good faith. As the Court mentioned, it is completely inexcusable for a tenant not to have read the lease before signing it and for him not to have sought to have it translated into a language he understood, since he did not understand French. It occurs frequently that parties execute contracts without reading them properly. This is a basic, but very important, recommendation.

Even if the text is clear, it still has to be applied correctly! A lessor recently learned this at his expense after failing to comply strictly with his own lease. In the case of *Bugnariu v. Ethier* (February 20, 2009) 2009 QCCQ 1790, Judge Alain Breault of Quebec Court had to rule, among other matters, on the validity of the lessor's claim for additional rent involving operating costs and taxes. With respect to property taxes, the lease stated that the lessor had to present copies of the tax bills and other evidence as well as a certificate attesting to the tenant's proportionate share; meanwhile, with respect to operating costs, he had to have a detailed statement showing "the charges, expenses, costs and outlays forming the Operating Costs and taxes, with this statement having to be certified

by the Lessor's auditors" [translation]. The judge came to the conclusion that these "invoices, statements, copies of account or certificates were not produced before the Court. Nor did the evidence reveal if they had been submitted in one way or another to the defendant. From this perspective, the simple affirmation that additional rent was not paid by the defendant is not legally satisfied" [translation]. Thus, the lessor's claim was rejected by the Court.

_COMPREHENSIVE LIST OF OPERATING EXPENSES: WISH LIST OR NIGHTMARE!

It is interesting to talk about operating costs, but what do they consist of in concrete terms? Below is a list of the various components of additional rent. This forms a comprehensive list of the operating costs that a lessor can potentially recover from his tenant. What may be a wish list for the lessor may turn into a nightmare for the tenant! In examining the broad scope of this list, one may be surprised by how much it contains. It may be worthwhile for a lessor to examine his leases against this type of list and also for a tenant to ensure, through a list of precise operating cost exclusions inserted into the operating cost clause, that these costs do not go beyond the real intent. This list is surprising; it includes an impressive number of expenses. Landlords and tenants, we leave it up to you to draw your own conclusions! •



LISTE EXHAUSTIVE DES DÉPENSES D'EXPLOITATION

– (Note : Le (E)) signifie des dépenses possiblement ou fréquemment exclues)

A COMPREHENSIVE LIST OF OPERATING EXPENSES

– (Note: "E" refers to expenses that are possibly or frequently excluded.)

UTILITIES

- Heating, ventilation, and air conditioning (HVAC).
- Electricity for parts of land and building not leased and occupied by tenants (including all applicable taxes) (E-as to vacant leasable space).
- Electricity furnished to or available for tenants (if electricity isn't individually metered or included in the rent bill).
- Gas, steam, and other fuel (including all applicable taxes).
- Telephone answering system for the building.
- Water charges (if not specifically reimbursed by tenants).
- Sewer charges – by the municipality or its agency (if not specifically reimbursed by tenants).
- Sewage disposal system and related costs.

- Hookup, connection, or service charges for all utilities (E).
- Installation and maintenance of all telecommunications equipment (if not specifically installed by the tenant).
- Cost of installing, maintaining, and repairing the building's intra building network cabling (INC).

BUILDING SERVICES

(This category should cover all areas of the building, its plazas, sidewalks, curbs, and parking areas).

- Painting all non-tenant areas.
- Decorating all non-tenant areas.
- Installing and maintaining art work and holiday decorations for any lobby and other public portions of the building (E – tenant will try to limit these costs rather than exclude them).
- Cleaning interior of common area windows.
- Exterior window cleaning.
- Washing inside windows in other tenants' space (E).
- Cleaning services.
- Janitorial service.
- Security systems (e.g., alarms, remote cameras, patrols).
- Initial cost of exterior and interior landscaping (E).
- Maintenance of exterior and interior landscaping.
- Plumbing.
- Tenant directories.
- Garbage and waste collection and disposal.
- Snow removal.
- Sprinkler system maintenance.
- Installation and maintenance of all fire/life safety systems or equipment (including any sales taxes or other taxes thereon) (E – regarding installation).
- Traffic control fees (e.g. Costs of signs, traffic guards).
- Legal fees (E – especially if

- incurred in the leasing of space, or in connection with a dispute with or default of another tenant).
- Accounting and bookkeeping fees (E – if for basic work that should be done by management).
- Auditing fees connected with operating expenses.
- Consulting fees related to ownership and operation of the property (E – regarding ownership).
- Architectural fees (E).
- Other professional fees incurred in connection with the operation or management of the land or the building (e.g., appraisers, surveyors) (E).
- Initial paving and painting of parking areas (E).
- Re-paving parking areas (including repainting the striping, fixing curbs and bumpers) (E – as to re-paving,

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since tenant will argue that this is a capital expense).

- Recycling costs.

Maintaining and repairing the following:

- Public bathrooms
- Loading and unloading areas
- Trash areas
- Roadways and sidewalks, elevators, escalators, and Stairways.

BUILDING MANAGEMENT

Salaries for people performing services in connection with the operation, repair, and maintenance of the land or building, including:

- Porters
- Maintenance workers
- Security personnel
- Building managers
- Leasing agents (E)
- Secretaries
- Office staff
- Promotions director (E- if for leasing purposes)
- Supervisory personnel (E)
- Owner
- Executives and officers of owner (E – unless it's for work that would have been included in operating expenses if it were done by a third party, e.g., accounting, and then only to the extent that compensation is no higher than it would have been to the third party).

Other employment costs of personnel:

- Any other compensation for services
- Social insurance contributions
- Unemployment insurance
- Workers' compensation insurance
- Liability insurance benefits
- Pension plan (E – but try not to

- give in on this)
- Medical insurance and hospitalization
- Retirement or welfare plans
- Insurance (including group life and disability) (E – but try not to give in on this)
- Uniforms and work clothes contributions
- Cleaning of work clothes/ uniforms
- Collective bargaining agreement expenses imposed on behalf of owner and related to employees
- Part-time employees' pro rata expenses
- Employees of independent contractor expenses
- Fringe benefits (E – but try not to give in on this)
- Force overtime compensation
- Any other related employee expenses (E).
- Cost of any space occupied by the property manager and leasing agent (E).
- Telephone and stationery costs.
- Dues, fees, and contributions paid to civic organizations and associations (E).
- Franchise fees or charges (E).
- Licence fees (E).
- Any fees or charges paid by you to any government agency for the privilege of owning, leasing, operating, maintaining, or servicing the land, building, or any of its equipment or property (E).
- Management/administrative fees or commissions paid to the managing agent (if there is no managing agent, an amount no higher than the prevailing management fee rates for similar properties) (E – tenant may want a cap on these fees).
- Payments made under any easement, operating agreement, licence, restrictive

- covenants, or any instrument pertaining to the payment or sharing of costs among property owners (E).
- All costs associated with a transportation demand management program.
- Materials and tools used in operating, cleaning, safety, security, renovation, replacement, repair, and maintenance.
- Advertising and promotional fees (E – if for leasing purposes such as advertising vacant space).

INSURANCE

Premiums you pay for the following types of insurance (unless you get reimbursement directly from the tenant or another entity).

- Loss of rent
- Casualty (all risks)
- Fire and extended coverage
- Boiler and machinery
- Sprinkler
- Plate glass
- Liability (public liability)
- Fidelity (E)
- Earthquake
- Payment of deductible under any insurance policy (E).
- Cost of insuring land, the building, and common areas.
- Other insurance needed to run and maintain the building.

TAXES

(Tenant may pay for some or all of these taxes separately under the "real estate tax" provision).

- Payroll tax (including an allocable share of off-site - personnel engaged in the operation, maintenance, and repair of the project) (E).
- Other taxes associated with employees.
- Business property tax.
- Personal property taxes on any

fixtures, machinery, equipment, furniture, or personal property connected with operation of the project.

- Gross receipt taxes (E).
- Commercial rental taxes or any similar tax (unless a direct expense of the tenant) (E).
- Transport taxes, fees, or assessments (e.g. Mass transit fee, trip fee).
- Fees assessed by air quality management authorities or any governmental or quasi-governmental entity regulating pollution.
- Sales or use taxes on any equipment, tools, or supplies (E – if for the purchase of capital equipment).

REPAIRS & REPLACEMENTS

(This category should cover all areas of the building, its plazas, sidewalks, curbs, and parking areas.)

Repairs to and replacement of the following (Some experts do not find it necessary to be this specific. These expenses overlap with those in the capital costs category below).

- Cables
- Fans
- Boilers
- Pumps
- Wiring
- Electrical fixtures
- Meters
- Elevators, escalators, stairways
- Sprinkler systems (E)
- Window washing equipment
- Snow removal equipment
- Security systems
- Life and safety systems (including fire)
- Irrigation systems
- Lighting facilities
- Fences and gates
- Surfaces and coverings
- Decorative items, carpets, drapes and window coverings.
- Major building repairs.

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- Structural repairs and replacements (e.g., to the roof, foundation, and building exterior walls) (E).
- HVAC (including, but not limited to, any replacement or retrofit necessary to comply with laws regulating or prohibiting the use or release of chlorofluorocarbons or hydrochlorofluorocarbons).
- Repairs and replacements necessitated by any present or future law, statute, regulation, or directive of any governmental agency.
- Repairs due to faulty workmanship or inherent structural defects (E).
- Major repairs in other tenants' leased space. (E – try hard not to give this up.) Repairs are a legitimate expense, even if they're made in another tenant's space.)
- Any other repair or replacement of any item or equipment needed to maintain or run the building (E).

CAPITAL COSTS

- Cost of any capital improvements as amortized (E – if you can include this, be prepared to argue over the amortization schedule: Whether or not it covers the useful life, you will want to include interest).
- Cost of alteration to the building or any modification or addition of any equipment or improvements mandated by any present or future law, statute, regulation, or directive of any governmental agency (E).
- Improvements, equipment, and machinery installed for the purpose of reducing energy consumption or other operating expenses (E – or capped at amount of savings).
- Improvements made to comply with air pollution control standards (E).
- Alterations to the building made after the base year by reason of requirements of the insurance board or your insurance company (E).
- Improvements made for other tenants or rent concessions made instead of improvements (E).

MISCELLANEOUS

- Depreciation of, or the rental cost or value (including applicable sales taxes) of, hand tools or other movable equipment used in operation, cleaning, safety, security, repair, or maintenance (E).

- Expenses incurred in removing an ex-tenant's property (E).

Source: Best Commercial Lease Clauses (Vendome Press)