

NEGOTIATION OF OPERATING EXPENSE “PASS-THROUGHS”
IN GROSS LEASES – TENANT EXCLUSIONS

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Every landlord lease form contains a litany of permissible direct expense “pass throughs.” Every tenant’s counsel counters the ever-expanding list of inclusions with its own list of exclusions. The following is recent example of tenant inclusions.

Exclusions From Direct Expenses. Notwithstanding the provisions of Section ____, Direct Expenses shall not include:

(a) Legal fees, brokerage fees, leasing commissions, advertising costs, promotional expenditures, architectural and engineering fees, and other similar expenses incurred in connection with (i) the leasing of space in the Building (including rental or other obligations to third parties or prospective tenants or occupants of the Building which Landlord pays or assumes) or other expenses (including the cost of Landlord’s leasing suite and space planning costs for tenants) incurred by Landlord in connection with the leasing of tenant space in the Building or (ii) the costs of the design and construction of tenant improvements to the Premises or the premises of other tenants;

(b) any costs (unless such costs would otherwise have been incurred by Landlord in the normal course of maintenance and repair and which are not otherwise excluded by the terms of this Section), including penalties and fees, incurred due to a violation, or responding to a potential violation, by Landlord or any tenant or occupant of the Building of any applicable laws including, without limitation, any applicable ordinance of the City of _____ pertaining to the installation/retrofit of fire sprinklers in the Building or the terms and conditions of this Lease or of any other lease, contract, easement, license, encumbrance or other obligation or agreement relating to the Building;

(c) any costs incurred in the event any portion of the Building is made untenable by fire, earthquake, or other casualty or by exercise of the rights of eminent domain or other cause, or to perform repairs or other work occasioned by loss or damage due to casualty or the exercise of rights or eminent domain, whether or not paid for by insurance or condemnation proceeds; provided that a customary deductible may be included within Direct Expenses;

(d) damage and repairs or any other costs necessitated by the negligence or willful misconduct of Landlord, or any of its employees, agents, vendors, contractors or providers of materials or services;

(e) wages, salaries and benefits paid to leasing agents, promotional directors and other personnel to the extent of time by such other personnel not actually allocated to the management, operation, administration, repair or maintenance of the Building, including the cost of pension plans, fringe benefits, medical insurance, group life and disability insurance, general welfare benefits, union contributions, payroll taxes and other related expenses in connection with the persons identified in this Section ____; provided, however, that in no event shall Direct Expenses include wages, salaries, and benefits paid to personnel of Landlord above the level of General Manager;

(f) legal fees, accounting fees, professional expenses and other related costs except those incurred in connection with the management, maintenance, operation and repair of the Building and expressly excluding such fees and costs incurred in connection with proposals, negotiations or disputes with tenants or other occupants of the Building or prospective tenants or occupants of the Building or associated with the enforcement of the terms of any lease (including unlawful detainer proceedings or proceedings for the collection of rent), requests to assign or sublet or the defense of Landlord's title to or interest in the Building or any part thereof, and the sale, transfer, financing or refinancing of the Building;

(g) any costs (including permits, licensing and inspection fees) incurred in renovation or otherwise improving, decorating, painting or altering space for tenants or licensees in the Building and including such renovations to any vacant space in the Building available or intended to be made available for leasing;

(h) any ground lease rental and any amortization interest, points, penalties, principal and other payments on mortgages and any other form of monetary encumbrance or any form of financing for Landlord relating to the Building, and any other cost or expense relating or required pursuant to any such mortgage, encumbrance or financing, if any, except as otherwise provided in Sections _____ and ____;

(i) depreciation on the Building or any Building components, systems or equipment, except as otherwise expressly provided in Sections ____, __ or ____;

(j) all items and services for which Tenant directly reimburses Landlord or pays third persons for such services which are otherwise not offered by Landlord to all tenants hereunder or which Landlord provides selectively to one or more tenants or occupants of the Building which are not customary for normal office use;

(k) any amounts owed by Landlord to other tenants and all costs incurred which are subject to direct reimbursement (or are reimbursed) by other tenants of the Building or other parties, including expenses for repair or replacement paid by proceeds of insurance in connection with any insurance (carried by Landlord, other tenants or by anyone else), through condemnation awards or by warranty claims;

(l) costs of capital improvements and equipment, defined in accordance with generally accepted accounting principles ("GAAP") except for those provided in Sections ____, ____ or ____;

(m) costs for alterations defined in accordance with GAAP as capital improvements and replacements, except as permitted in Section ____ above or in Sections ____, ____ or ____;

(n) costs defined in accordance with GAAP as of a capital nature, including, without limitation, capital improvements, capital repairs, capital equipment, and capital tools, except as permitted in Sections ____(i), (j), (k) or (n);

(o) Landlord's general corporate or partnership overhead and general and administrative expense and costs associated with the operation of the business of the partnerships or other entities which constitutes Landlord, as distinguished from the costs of the management, operation, repair and maintenance of the Building, including, without limitation, accounting and legal costs, costs of defending lawsuits with any mortgagee, costs of selling, syndicating, financing, mortgaging or hypothecating any ownership interest in Landlord or any of Landlord's interest in the Building and costs incurred in connection with any disputes between Landlord and its partners, between Landlord and its employees (and not reasonably related to the operation and management of the Building (disputes which would be so reasonably related would include minor disputes in the normal course of its operation and management of the Building, but would not include, for example, sexual harassment, discrimination or wrongful termination claims)), between Landlord and any other owner of an interest in the Building, between constituent partners of Landlord, between Landlord and building management or between Landlord and other tenants or occupants;

(p) any compensation paid to clerks, attendants, or other persons in commercial concessions operated or subsidized by Landlord or operated by others in the Building or in the Garage;

(q) except as permitted by Section ____, rentals and other related expense incurred in leasing air-conditioning systems, elevators, or other equipment ordinarily considered to be of a capital nature, except (i) where such equipment is rented for purposes of making repairs or keeping permanent systems in operation while repairs are being made; and (ii) equipment not affixed to the Building which is used in providing janitorial or similar services;

(r) advertising and promotional expenditures and costs of acquisition and maintenance of signs in or on the Building identifying the owner of the Building or other exterior signage granted to other tenants of the Building;

(s) services provided, taxes attributable to, and all other costs and expenses incurred in connection with the operation of any retail or restaurant operations in the Building;

(t) costs arising from Landlord's charitable or political contributions;

(u) costs for the acquisition of sculpture, paintings, or other objects of fine; provided that Direct Expenses shall include the costs of maintaining, insuring and securing such items in the Common Areas only;

(v) damage awards (or settlement payments) or other costs paid by Landlord arising from Landlord's breach of contract or tortious acts and penalties, fines, late payment charges or interest incurred as a result of the late payment by Landlord of any Direct Expenses;

(w) any bad debt loss, rent loss or any reserves, including reserves for capital items, bad debts or rental losses, or for future Direct Expenses or taxes;

(x) amounts paid to Landlord, or to subsidiaries of Landlord for goods and/or services furnished for the Building to the extent the same exceeds the costs of such goods and/or services furnished to Comparable Buildings when rendered by unaffiliated third parties on a competitive basis;

(y) any utility costs for which any tenant or occupant of the Building directly contracts with the local public utility company;

(z) any travel and entertainment expenses of Landlord, any management agent of Landlord and their respective employees, agents and affiliates;

(aa) costs incurred by Landlord in connection with any audit of Direct Expenses and/or Taxes initiated or requested by tenant of the Building other than Tenant;

(bb) any costs incurred in connection with any major change or alteration in the Building, or any portion thereof, such as adding or deleting floors;

(cc) any cost, interest or tax penalties incurred as a result of Landlord's negligence, inability or unwillingness to make tax payments (or to file tax filings or returns) when due;

(dd) any costs incurred by Landlord due to the violation by Landlord or any tenant of the terms and conditions of any lease of space in the Building or of any laws or costs incurred by Landlord due to the violation by Landlord of any covenant or agreement affecting the Building;

(ee) any costs expressly excluded from Direct Expenses elsewhere in this Lease;

(ff) costs incurred in connection with disputes with present or prospective tenants or other occupants of the Building;

(gg) any costs relating to the actual, alleged or threatened, presence, storage, removal, remediation, investigation, maintenance, containment or treatment of any substance identified as a hazardous substance under applicable laws or customary industry standards in, on, about, under or adjacent to the Building, including without limitation, in connection with any effort to comply with any law;

(hh) any costs with respect to the implementation or installation of any improvements, corrections, repairs or replacements of structural elements of the Building or any

seismic safety, retrofit or enhancement program or any costs of repair, replacement or correction of defects relating to any tenant or other improvements in the Building;

(ii) any costs, fees, dues, contributions or similar expenses for industry associations or similar organizations except as otherwise provided in Section ____;

(jj) any costs incurred in removing and storing the property of former tenants or occupants of the Building;

(kk) any costs of installing, operating and maintaining any observatory, broadcasting facility, luncheon club, athletic or recreational club or child-care facility;

(ll) any costs related to any governmental, quasi-governmental, utility company or similar program or plan for waste, traffic, hazardous waste (other than the reasonable cost of any waste recycling programs which are reasonably consistent with the recycling programs of Comparable Buildings), environmental or handicapped access management, mitigation, enhancement or remediation in which participation is voluntary;

(mm) any costs recovered by any warranty, rebate, guarantee or service contract (which shall not prohibit Landlord from passing through the costs of any such service contract if otherwise includable in Direct Expenses);

(nn) any costs, expenses, assessments, fees and other payments pertaining or relating to:

(i) Any CC&Rs, easements, use restrictions or deed restrictions encumbering the Building not in effect during the Base Year;

(ii) Any document or instrument imposed for, or relating to the grant of entitlements for (or development of), the Building (including those relating to low or moderate income housing, arts fees, housing replacement, school or child-care facilities, transportation impact management or mitigation fees, special assessment districts, parking management fees, recycling fees, infrastructure payments or fees or similar payments); or

(iii) Any future development or redevelopment of the Building (including, without limitation, any of the same which would not be incurred, paid or payable if the Building were not further developed or redeveloped);

(oo) any costs of any parties, ceremonies or other events for tenants, Landlord or third parties which are not tenants of the Building;

(pp) any direct or indirect costs incurred in connection with the ownership, operation, management, maintenance and repair of the Garage (other than costs relating to taxes and insurance, and the costs of maintaining and repairing those areas of the Garage if any, used to house Building systems such as the chillers and pumprooms and emergency lighting);

(qq) any costs of installing, operating and maintaining any other service operated or supplied by, or normally operated or supplied by, a third party under an agreement between a third party and a landlord which service is normally supplied by a landlord or such third party in Comparable Buildings; and

(rr) costs incurred by Landlord in connection with rooftop communications equipment of Landlord or other persons, tenants or occupants of the Building, unless required by law or for safety purposes or costs relating to equipment for all of the tenants of the Building.

Computation of Direct Expenses. Direct Expenses shall be computed in accordance with the following general principles:

(a) Recovery Limited to Actual Costs. Landlord shall not recover the cost of any item more than once.

(b) Arm's Length. All services rendered to and materials supplied to the Building shall be rendered or supplied at a cost comparable to those charged in arm's-length transactions for similar services or materials rendered or supplied for similar purposes to comparable buildings.

(c) Retail Excluded. The cost of all services provided to or for the specific benefit of the retail tenants in the Building which are not provided to or for the benefit of the office tenants in the Building (such as special janitorial or maintenance services) shall, in all cases, be excluded from Direct Expenses.

(d) Reimbursements. All discounts, reimbursements, rebates, refunds or credits (collectively, "Reimbursements") attributable to Direct Expenses received by Landlord in a particular year shall be deducted from Direct Expenses in the year the same are received; provided, however, if a particular Reimbursement exceeds Fifty Thousand Dollars (\$50,000.00) and applies to a prior year, such Reimbursement shall be applied to such prior year (and Tenant's Percentage Share thereof shall be promptly refunded) but in no event shall Tenant's refund exceed the amount of Increased Direct Expenses actually payable by Tenant in such year.

(e) Non-Building Exclusive Expenses. Whenever expenses are paid or incurred by Landlord as a result of activities which are not exclusively rendered to the Building, only that portion which can be reasonably allocated to the Building shall be included within Direct Expenses.

(f) Installments. All assessments and premiums of Direct Expenses which can be paid or incurred by Landlord in annual installments shall be paid by Landlord in the maximum number of annual installments permitted by law and shall not be included as an Direct Expense except in the calculation year in which the installment is actually paid; provided, however, that if the then prevailing practice in other comparable buildings is to pay such assessments or premiums on an earlier basis and Landlord shall pay the same on such basis, such assessments or premiums shall be included in Direct Expenses as paid by Landlord.

(g) Reasonableness. Landlord shall use its reasonable efforts to operate and maintain the Building and all Common Areas in an economically reasonable manner.

TERRORISM INSURANCE AND DIRECT EXPENSES

Recent events (September 11th and enactment of the Terrorism Risk Insurance Act of 2002 (the "Act")) have had significant effects on direct expenses billed by landlords. The 9/11 attack resulted in skyrocketing insurance costs, particularly for "terrorism insurance." The precipitous climb in costs was followed by a fall in terrorism insurance costs by virtue of the passage of the Act. Such wild fluctuations in insurance costs can wreak havoc with gross lease base year operating expense "pass-throughs." Operating Expenses will be abnormally high in a base year which includes post 9/11 and pre-Act terrorism insurance expenses. In subsequent years, the insurance cost reduction will "eat up" normal increases in insurance and other operating expenses. What follows is an attempt to "level out" the terrorism insurance spike caused by 9/11 and to return escalation recaptures to normal.

Premiums and other charges (including costs of claims adjustments) for insurance and deductible amounts under the terms of such insurance, including, without limitation, all risk, earthquake, terrorist, flood, public liability, environmental, property damage and workers' compensation insurance, and such other insurance coverage in such amounts as Landlord, in its sole discretion, shall elect to maintain. [Notwithstanding the foregoing, Landlord may, on one occasion, adjust the component of Operating Expenses for the Base Year attributable to the cost of insurance premiums for coverage against acts of terrorism ("Terrorism Insurance Premiums") to an amount equal to the Terrorism Insurance Premiums incurred by Landlord for the Building during calendar year 2004. Thereafter, if the Terrorism Risk Insurance Act of 2002 (the "Act") expires or is repealed, then, as to any subsequent comparison years, Landlord shall again readjust the Terrorism Insurance Premiums component of Base Year Operating Expenses to be an amount equal to the lesser of (a) the Terrorism Insurance Premiums actually payable during the Base Year; and (b) the Terrorism Insurance Premiums first payable by Landlord which reflect the expiration or repeal of the Act.]