



Oregon Real Estate Continuing Education

NNN V. GROSS LEASES –

NEGOTIATING EXPENSES REIMBURSEMENT PROVISIONS FOR BROKERS

CE Course # 2019-001

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1. Different Types of Leases for Tenant Expense Obligations

- A. True Gross Lease – Tenant pays agreed upon rent and Landlord pays all expenses (taxes, insurance costs and operating expenses) with no pass throughs. Tenant may pay some utilities directly to utility provider.
- B. Base Year Lease (aka Full Service Lease) – Tenant pays agreed upon rent. Tenant pays no expenses during the base year, but each year thereafter Tenant pays the amount of all increases in expenses over the expenses in the base year.

Tip when representing the Tenant – be sure that the expenses for the base year are fully stabilized; otherwise base year expenses may be lower than “market” and will thereafter initially increase at a faster rate, resulting in a shifting of costs to Tenant.

- C. Expenses Stop Lease – Tenant pays agreed upon rent and all expenses above a specified dollar amount.
- D. Common NNN Lease – Tenant pays agreed upon rent and Tenant’s share of expenses relating to the ownership and operation of the Property (but often not certain capital costs, or at least capital costs are amortized if passed through).
- E. Absolute NNN Lease – Tenant pays agreed upon rent and all costs related to the operating of the Property (a ground lease and sometimes a single tenant lease for a Property).

2. Tenant’s Pro Rata Share of Expenses

- A. Area of Premises/Area of Building
 - (i) Solution from Tenant standpoint is to “gross up” operating expenses to portray the Building as fully constructed and substantially leased (often to 95% occupancy). Should the gross up be for all expenses or just those expenses that vary with occupancy (such as utilities and certain repair and maintenance costs)?

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- (ii) Actual area leased to tenants
 - B. Rentable area/load factor – BOMA/NAIOP measurements
 - C. Multi-building projects – some expenses based on share of Building and some expenses based on share of Project
 - D. Ability of Landlord to equitably adjust Tenant’s Pro Rata Share for: (i) a particular expense allocated to a limited number of tenants for some reason, (ii) re-measurement of the rentable area, and (iii) Project/Building size expands or contracts.
 - E. Mixed use projects – do all types of tenants of the Building/Project really “consume” expenses at the same rate? Consider requiring retail tenants for a building that is primarily an apartment building to pay a fixed amount with annual escalations to avoid hassle of calculating expenses pass through amounts.
 - F. Non-profit tenants and provision that excludes non-profit tenant’s obligation to pay taxes to the extent the non-profit tenant gets an exemption (consider issues related to fact that exemption runs from July 1 to June 30).
3. **Tenant General Expense Concerns**
- A. Landlord does not recover more than 100% of Landlord’s costs.
 - B. Landlord allocates personnel costs (wage and all cash benefits in a compensation package, non-cash costs such as uniforms and cleaning supplies and replacement of hand tools) among all buildings served by such personnel.
 - C. Landlord provides personnel services at competitive costs.
 - D. Expenses are adjusted to reflect credits or discounts received by Landlord (example is if Landlord pays taxes in a single installment or if Landlord gets taxes reduced).
 - E. Tension exists between the level of service that Landlord provides (Tenant wants a high level of service) and the cost Tenant must pay for such services. Tenant should consider specifying a minimum level of services. This could include the level of janitorial services or acceptable temperature ranges or something as simple as a level of services consistent with the level of services provided by owners of building similar to the Building located within a certain distance from the Building.
 - F. Consider green lease trend in which electricity is sub-metered to some tenants and how this affects expenses.
 - G. Consider where a Tenant may perform certain work that is otherwise performed by Landlord for other tenants of the Building/

Project (such as a tenant performing its own janitorial or HVAC maintenance).

4. **Expense Inclusions**

- A. All costs of operating, managing, maintaining, insuring, repairing and replacing the Building/Project, followed by an "including, without limitation" list that also includes real estate taxes.
- B. Typical inclusions:
 - (i) Materials, utilities, goods and services
 - (ii) Wages and benefits and costs of employees
 - (iii) Janitorial, maintenance and security services
 - (iv) Repairs and replacements (but capital items amortized over an agreed upon time period (such as 10 years or useful life) with an agreed upon interest factor)
 - (v) License, permit, inspection fees
 - (vi) Accountant fees related to expenses
 - (vii) Legal fees related to operation, maintenance or repair costs
 - (viii) Management fees (consider capping as % of gross rents, % of base rents or % of operating expenses)
 - (ix) Insurance costs (consider limiting types of insurance and limiting amount of deductible)
 - (x) Real estate taxes
 - (xi) Costs related to CC&Rs affecting property
 - (xii) Any other costs and expenses commonly incurred by similar owners of buildings similar to the Building/Project.

5. **Expense Exclusions**

- A. Limit to common areas in retail?
- B. Consider having a specific list of exclusions instead of an "including, without limitation" list?
- C. Exclude "replacements"?
- D. Typical exclusions:
 - (i) Ground lease/master lease rent
 - (ii) Capital repairs/capital replacements

- (iii) Rental of items if purchased would be capital items
- (iv) Costs of repair required to be insured by Landlord (consider limiting to the extent of insurance proceeds received)
- (v) Costs of negotiating leases/TI costs
- (vi) Depreciation
- (vii) Financing costs
- (viii) Marketing costs
- (ix) Expenses for services/benefits that are not offered to tenant or for which tenant is charged directly but that are provided to another tenant of the Building/Project (such as electricity in a "green lease)
- (x) Costs to cure a violation of law
- (xi) Overhead/profit paid to Landlord
- (xii) Costs of services paid to affiliate where cost exceeds what it would be if paid on a competitive basis
- (xiii) Landlord's general corporate overhead and general administrative expenses
- (xiv) Costs services provided to a unique tenant (such as a restaurant)
- (xv) Costs to comply with laws (such as ADA)
- (xvi) Costs to make upgrades to the Building/Project
- (xvii) Costs arising out of the negligence of Landlord or other tenants
- (xviii) Hazardous materials remediation costs
- (xix) Charitable contributions
- (xx) Costs to correct defects
- (xxi) Costs for art
- (xxii) Costs of resolving disputes
- (xxiii) Costs associated with the operation of Landlord's business
- (xxiv) Entertainment expenses/holiday decoration expenses
- (xxv) Reserves

(xxvi) Any expenses not normally treated as expenses by owners of buildings similar to the Building/Project within an agreed upon vicinity of the Building/Project

6. **Caps on Controllable Expenses**

- A. Cumulative cap vs Non-cumulative cap
- B. What are "controllable expenses" – expenses other than:
 - (i) Taxes
 - (ii) Insurance costs
 - (iii) Utilities
 - (iv) Snow removal
 - (v) Non-recurring costs – "expenses that are not customarily incurred and budgeted for by owners of comparable projects in the _____, _____ area, or are materially in excess of such customary and budgeted costs, such as costs incurred due to unusual weather (i.e. snow and ice removal, wind damage, excessive ground water), labor trouble, shortages in supplies, utility shortages or black-outs and costs that may arise in connection with a force majeure event"
- C. Consider re-setting 'base year' of controllable cap in the event tenant renews term of the lease.

7. **Audit Rights**

- A. Limit period within which Tenant can seek an audit after Landlord provides operating expense statement.
- B. Limit Tenant look back.
- C. Prohibit contingency fee audits.
- D. Require confidentiality.
- E. Limit extent of documentation to summary statements.
- F. Include a dispute resolution procedure if Landlord disagrees with Tenant's conclusions.
- G. If independent CPA finds Tenant overpaid operating expense, limit "reimbursement of audit expenses" to cost of the independent CPA based on the amount of the over payment (Tenant pays costs of audit if overage is less than 5%; Landlord pays costs of audit if overage is more than 5%).

