



Client Alert

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Your Landlord is Sending You a Bill. Does Your Office Lease Require a Blank Check?

As 2009 begins, your landlord is performing its annual reconciliation of the costs and expenses associated with operating your building in 2008. Its goal is to pass through to you, the tenant, every expense permitted under your lease. Since your annual bill should be arriving shortly, now may be a good time to re-acquaint (or, in some cases, acquaint) yourself with how your landlord passes through its building operating expenses.

Landlords are in business for the same reason as any other business— to make money. A landlord's profitability, even survival, is dependent upon seeking the maximum reimbursement from its tenants for its building operating expenses. Operating expenses include items such as common area maintenance, real estate taxes, property management fees, building utility charges and insurance. With office vacancies on the rise, the burden of these expenses is commonly falling upon fewer and fewer tenant contributors.

Most office leases contemplate the payment by tenants of a "pro-rata" share of a building's operating costs, whereby each building tenant pays its relative share of the building's total expenses. Some of these leases may also apply a "base year" concept, so that a tenant pays its pro-rata share of operating expenses in excess of the operating expenses incurred in the applicable "base year". After a little digging into the operating expense language of your lease, you may discover that the true spirit of the "pro-rata" concept applies only if the building is fully-leased and occupied. If your office building is like most others in today's market, there are probably a number of vacancies, and a poorly negotiated lease can leave the remaining tenants with the obligation to subsidize the operating expenses of a landlord unable to lease-up its building. The gravamen of the issue is what is to be included in, and what is to be excluded from, the numerator and denominator of the fraction used to calculate a given tenant's pro-rata share.

Take, for example, the distinction between "*leased floor area*" and "*leasable floor area*" that you may find in the operating expense language of your office lease. The difference may seem benign, but the bottom-line consequence to a tenant's operating expense pass-through could prove substantial. More onerous landlord-oriented lease forms may impose upon a tenant the obligation to pay its pro-rata share of the building expenses, with such pro-rata fraction calculated as the tenant's square footage divided by the "*leased floor*

area” of the building, rather than the “*leasable* floor area” of the building. If a tenant is the sole remaining occupant of a struggling building, the seemingly innocuous “*leased*” vs. “*leasable*” distinction may place upon that tenant the burden of paying 100% of the building’s total operating expenses. This is a dramatic example, but a frightening reality nonetheless.

A well-negotiated lease may offer solace to the cost-conscious tenant, and a variety of options exist to shift away from the tenant some of the cost-risk of an under-performing building or an over-spending landlord. Landlords commonly grant “caps” on certain expenses, and “floors” upon the number of tenants contributing to them. Both options provide increased predictability to you as a tenant. Well negotiated operating expense language should place upon a landlord reasonable limitations as to the expenses reimbursable by tenants, while incentivizing the landlord to spend its tenants’ reimbursements prudently.

If a review of your lease’s operating expense language reveals that you’re not as protected as you had hoped, the relatively short-term nature of many office leases could mean that an opportunity to renegotiate is just around the corner. Even if that is not the case, in today’s market landlords are listening, and 2009 may be the right time to renegotiate some of the blank check operating expense provisions in your office lease. Your landlord may offer some attractive concessions as a quid pro quo for your agreement to extend your lease term, expand your premises, or remove a lease termination right.

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