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"OPERATING COSTS"

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In this article, I have set out to answer the following questions frequently encountered in the field of commercial leasing in Canada:

- Are any capital expenditures properly recoverable as Operating Costs?
- Is there any difference between depreciation and amortization and where exactly does GAAP fit into the discussion?
- Salaries and administration/management fees – are they duplicative?
- How do gross-ups to full occupancy levels work?

Part I – Capital Expenditures/Amortization and Depreciation

The definition of "Operating Costs" in most commercial leases specifically includes capital costs, although tenants generally take the position that they should not be responsible for them.

The meaning of the phrase "capital costs" and/or "costs/expenditures of a capital nature" is virtually impossible to discern from the case law. Most of the case law deals with income tax issues where the question has to do with whether certain costs (e.g. legal fees) incurred in connection with an asset are or are not part of the capital cost of the asset, but not whether the cost of the asset itself qualifies as a capital cost.

It is somewhat helpful to note that in Canada, the cases all tend to rely on one Supreme Court ruling (*Montreal Light, Heat & Power Consolidated v. Minister of National Revenue, [1942] S.C.R. 89*) in which the usual test of whether an expenditure is one made on account of capital is expressed to be, "was the expenditure made with a view of bringing into existence an advantage for the enduring benefit of the business".

Another quandary arises from the frequent use, in many lease definitions of "Operating Costs" of the phrase "capital costs in accordance with generally accepted accounting principles". These add-on words suggest that some guidance is to be found in accounting materials that might spell out generally accepted accounting principles, but even the Canadian Institute of Chartered Accountants (CICA) Handbook does not use the term "capital costs", preferring the concept of "betterment". As to generally accepted accounting principles, these are widely recognized as not centrally documented and not very rigid, but generally requiring consistency of treatment of any given type of expense, from one year to the next. However, the CICA Handbook does define "capital assets" as identifiable property, plant, equipment and intangible properties that:

(a) are held for use in the production or supply of goods and services, for rental to others, for administrative purposes or for the development, construction, maintenance or repair of other capital assets;

(b) have been acquired, constructed or developed with the intention of being used on a continuing basis; and

(c) are not intended for sale in the ordinary course of business.

All of the foregoing criteria must be met for the asset to be considered capital. As a corollary, we can conclude that an expenditure incurred to create, acquire or improve a capital asset would amount to a capital cost. But, an expenditure incurred to *repair* a capital asset would not qualify as a capital cost. And clearly, a cost incurred (e.g. advertising) to generate revenue or operate the business (e.g. employee wages, rent) would not constitute a capital cost. Examples of capital expenditures in the context of a commercial lease include: the installation of a new heating system[1], the cost of replacing the majority of a roof[2], and the costs of paving, lighting and striping a parking lot that had been previously unpaved and unlit.[3]

There is often considerable debate concerning which capital costs will be included in Operating Costs under a net commercial lease and how those costs are to be passed on. The debate relates to whether capital costs will be fully charged in the year in which the cost was incurred, whether

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[1] *Tom Jones and Sons Ltd. v. Obodynski*, [1993] O.J. No. 1135 (Ont. Ct. J. Gen Div.).
[2] *Alderman Holdings Inc. v. McCutcheon Business Forms Ltd.*, [1997] O.J. No. 4386 (Ont. Ct. J. Gen Div.).
[3] *789247 Ontario Inc. v. 215 Piccadilly Properties Inc.*, [1992] O.J. No 1214 (C.A.).

the expenditure will be amortized, whether interest will be charged on the unamortized portion, and what method of amortization will be used.

The Canadian Institute of Chartered Accountants defines amortization as "the writing off, in a rational and systematic manner over an appropriate number of accounting periods, of a balance in an account". [4] The CICA Handbook no longer uses the term "depreciation" but the Canadian *Income Tax Act*[5] still does. The elimination of the defined term "depreciation" from the CICA Handbook is not particularly meaningful, although its absence may tend to confuse commercial lease administrators. Although pursuant to the *Income Tax Act*, expenditures on account of capital are to be depreciated according to schedules set out in regulations to the *Income Tax Act*, with only the depreciated component of the cost (plus interest on the un-depreciated capital cost) being capable of being charged against income, this tax treatment is usually irrelevant to the recovery of so-called "Operating Costs" under net leases. "Operating Costs" are usually defined in commercial net leases to permit some degree of amortization (and/or "depreciation" – with the intent being the same), and the recoverability thereof is entirely a function of what the lease says.

Curiously, some leases allow the recovery through Operating Costs of "amortization, but not depreciation". It appears that the intention might be to allow certain costs, incurred to replace and/or improve an asset, to be spread out and recovered over a period longer than a year, but to disallow recovery of the original cost of the initial acquisition on a 'sinking fund' basis. So for example, the initial cost of cladding an office building, or of paving a plaza parking lot, cannot be "depreciated" through Operating Costs with a view to having reserve funds available (i.e., as a pre-payment) for the inevitable replacement cost that will be incurred several years later. However, where a re-cladding or re-paving becomes necessary several years after the initial capital outlay, the cost of the replacement can be "amortized" over a period. Thus, what seems to some as a distinction without a difference is an important distinction that seems to be rooted, not in accounting terminology or common law but perhaps, in a general business understanding of 'industry standards'?

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[4] *Terminology for Accountants,* 4th Ed., The Canadian Institute of Chartered Accountants, 1993, p. 11.
[5] R.S.C. 1985, c. 1 (5th Supp.), Section 13.

The effect of amortizing or depreciating capital costs is to spread out the cost over time. The most common method of amortizing a capital expenditure is by "straight line" method to zero over the useful life of the expenditure. For purposes of leases, some landlords like to use an alternative approach to the straight-line method – they will use a "variable" or "accelerated" method. For example, if snow removal or other variable costs are low in one year, some landlords will take the opportunity to accelerate amortization so that the Operating Costs rate does not decline with the reduction in variable costs. This can lead to higher amortization charges one year than the next, but the overall Operating Costs rate remaining constant or increasing at a modest annual rate. The intent of most landlords using this method is to 'smooth'. Tenants dislike this approach as it smacks of manipulation. Moreover, if the lease stipulates that amortization is recoverable "in accordance with generally accepted accounting principles", it is unlikely that "smoothing" would qualify as GAAP calls for consistency from one fiscal period to the next.

A sub-issue related to amortization arises where a tenant under a new lease pays amortization relating to an expenditure incurred prior to the lease commencement date. Some tenants maintain that such historical costs should not be payable by the tenant any more than the first tenant entering a new building would pay for the cost of constructing the building. In effect, tenants postulate that their basic rent constitute the "price of admission" for leasing the property as-is, such that its obligation under a net lease is to pay for ongoing costs of maintenance, repairs and operations incurred after the lease commencement date, but not past repairs, replacements or upgrades. Even a renewing tenant can argue that its renewal rent reflects the new value of the property, despite having willingly paid such amortization as a recoverable operating cost under its lease in the years/months leading up to the renewal. The main point to take from this analysis is that if the landlord wishes to recover historical amortization costs from a new tenant, the lease must expressly provide for it, as there does not seem to be any generally prevailing industry-wide view that the amortization of past expenditures is within the ordinary realm of "Operating Costs", nor is there any case law that deals with or supports this approach.

Another issue related to amortization has to do with interest. Landlords theorize that since the cost of *replacing* (or performing major repairs to) certain capital assets (e.g. roof membrane,

paving) is incurred to operate the property (as distinct from costs incurred to add value to the property), this cost could be recovered as a direct charge for the full amount in the year the cost is incurred. It takes very little for landlords to conclude that, having agreed to defer the cost by recovering it through Operating Costs on an amortized basis, they should be entitled to recover an interest cost (at the prime rate from time to time, or at prime plus *x*) on the unamortized portion. It must be noted that in the absence of lease provisions expressly permitting recovery of amortization or interest on unamortized amounts, no such charges may be passed through. However, depending on how the lease is written, the full cost of a replacement may be fully recoverable in the year incurred.

Tenants take the position that basic rent should comprise their consideration paid for the use of a fully complete, properly constructed building and that any ongoing modifications to that asset should be to the account of the landlord. However, the life expectancy of certain functional components of a building is much shorter than that of the structure. For that reason, negotiations of Operating Cost provisions with strong tenants tend to centre around the inclusion or exclusion of the following capital repair or replacement items: (i) substantial re-cladding (including re-glazing), (ii) replacement or substantial rebuilding of the central chillers and boilers, elevator motors or elevator control systems, (iii) replacement of a substantial portion of the roof membrane; (iv) improvements to or upgrades of life safety, fire prevention or security systems; and (v) renovations; whereas the following items are generally not considered to be contentious: (vi) ordinary repairs and maintenance of the cladding (including glazing), (vii) periodic replacement of insubstantial portions of exterior windows, (viii) relamping, (ix) resurfacing insubstantial portions of the parking facilities or insubstantial portions of the roof, (x) replacement of motors or compressors having a short useful life, and (xi) costs incurred for the purpose of reducing Operating Costs. (e.g. energy-saving equipment).

Sometimes landlords and tenants make an attempt to eliminate complexity by stipulating in the lease that any item costing in excess of a stated amount will be ‘deemed capital’ and require either exclusion or amortization, with the corollary that an item costing less than the stated amount will be ‘deemed non-capital’ and recoverable.

We cannot leave this topic without noting that landlords also seek to recover an administrative or management fee on both the amortized component of a recoverable cost and interest on the unamortized portion. Tenants theorize that this is a gravy train, since no particular effort deserving of an administrative or management fee is required to amortize a cost or track the interest on it. While this argument may have some validity in relation to the interest component, it must be observed that the amortized component would have attracted the administrative/management fee had it been charged fully in the year incurred. This naturally takes us to the topic of whether any administrative/management fee can ever be justified.

Part II – Management/Administrative Fees

A net lease typically provides that the landlord may recover, through Operating Costs or some other "additional rent" provision, a fee for its administrative and/or management services in connection with the property. These fees sometimes take the form of "Administration Fees" calculated as a percentage (generally 15% but sometimes 5-10% or even 18-20%) of Operating Costs, and other times take the form of "Management Fees" calculated as a percentage (generally 4% but sometimes 2-3% or even 5%) of the gross revenues generated by the property (including all rents). Landlords perceive these charges as fair compensation for their work, whereas tenants perceive these charges as a grab. Considering that landlords generally recover (through Operating Costs) the costs of salaries and benefits of staff hired to carry on the property management function, it must be acknowledged that the debate, over whether administration/management fees are pure profit centres, has never been resolved and likely never will.

Emotional detachment from the issue may be achieved through a consideration of what the Canadian courts have had to say about these fees over the years:

In *Hardwick & Hardwick Meats Ltd. v. 471447 Ontario Ltd.*[6], the Court held that the term "carefree" meant the equivalent of "net net", and that under that type of lease the landlord was entitled to pass on to the tenant any and all expenses that were incurred in the operation of the

[6] [1991] O.J. No. 2057 (Ont. Ct. Gen. Div.).

plaza, included the installation of a canopy, the replacement of tiles, paving, replacement of the roof and *imputed management fees for management services performed by the principal of the Landlord and members of his family.* There was no specific language in the lease that called for these charges to be included, but the Court relied on the general "netness" language to arrive at its conclusion.

In *789247 Ontario Inc. v. 215 Piccadilly Properties Inc.*[7], the Ontario Court of Appeal held that the landlord was entitled to contract out for the maintenance of the building and if the maintenance contract included a management fee that was paid by the landlord, then all costs (including the management fee) incurred under the contract were properly charged on to tenants. The lease provision permitting the landlord to collect 10% of its operating costs as an administrative fee was interpreted as *also* permitting the landlord to collect the 10% on the management contract fee.

In *Faema Co. (Canada) v. Hammerson Mississauga Inc.*[8], the Court interpreted the expression "absolutely net lease to the landlord" and held that the depreciation or amortization of equipment used to operate the shopping centre was properly included in Additional Rent, but that the administration fee of 15%, not having been expressly agreed to by the parties, was not within the scope of a net lease. The Court found the administration fee of 15% of the operating costs to be "an arbitrary surcharge to subsidize the [landlord's] cost of internal management [which] clearly [fell] outside the scope of what was contemplated by the agreement to lease".

In *Carbrig Holdings Ltd. v. Olympia Tile International Inc.*[9], the Court held that general "net lease" language was insufficient to conclude that management contract fees could be charged to the tenant. The Court was of the view that if the landlord had intended to recover management fees, it could have included a reference to them in the lease. Since it did not do so, the Court would not permit the landlord to recover this charge which the parties did not bargain for.

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[7] *Supra* note 3.
[8] [1991] O.J. No. 627 (Ont. Ct. Gen. Div.).
[9] [1992] O.J. No. 884 (Ont. Ct. Gen. Div.).

In *R. Denninger Ltd. v. Metro International General Partner Canada Inc.*[10], the phrase "absolutely net to the lessor" was again interpreted as being insufficient to permit a landlord to charge a tenant for "the performance of the landlord's duties by an agent of the landlord". The Court held that the property manager was performing the landlord's ordinary duties, and that the tenants should not have to pay for the property manager's fee for "performing functions that the landlord would normally perform for itself". Further, *the landlord's purported administrative fee, being an attempt to recover internal costs of office expense, management salaries, travel expenses, bank charges etc. was found not to be applicable to the maintenance and operation of the shopping centre*, and as such it could not be charged to the tenant despite the "absolutely net" phrase.

In British Columbia, the Court of Appeal upheld lease provisions that required the tenant to pay to the landlord an administrative fee <u>as well as</u> management contract fees. In the case of *Han v. 9938 Investments Ltd.*[11], the lease included, under the definition of "Operating Costs", "fees ... payable to firms for ... property management", as well as "an administrative overhead charge equal to 15% of the costs [included in Operating Costs]". The Court was not persuaded that the charges were either inappropriate or in duplication of each other, and allowed the landlord to recover <u>both</u> from the tenant.

Clearly, what emerges from the cases is that if parties wish to recover administrative fees and/or management fees, it is important to ensure that specific language reflecting these terms is included in the governing agreement.

From a “first principles” perspective, it is easy to see where landlords and tenants are likely to part company. If it can be agreed that a landlord should be compensated for its effort, and if it can be agreed that a method of determining that rate of compensation should be tied to an arbitrary percentage of either costs or revenues generated by a property, it must be said that this agreement has been reached solely as a function of market conditions and not because generally, tenants think this is the best way to arrive at a fair rate of compensation. Of course, when

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[10] [1992] O.J. No. 838 (Ont. Ct. Gen. Div.).
[11] (1995), 45 R.P.R. (2d) 100 (B.C.C.A.).

‘industry norms’ are expressed (and they often are - “everyone” is familiar with the 10-15% of Operating Costs scheme, and “everyone” has also heard of the 3-4-5% of gross revenue scheme), they are expressed in broad strokes and the fine tuning is left to the lease negotiators. The business people will arrive at the percentage figure readily enough, but where the negotiations break down is in the determination of what can fairly be susceptible to the application of the percentage.

One of the biggest areas of disagreement in the discussion over what to exclude from the application of administration/management fee is salaries of staff employed to operate a property. Generally, wages paid to site-level staff performing physical maintenance functions are not contentious. But the bigger the property, the bigger the landlord, and the bigger the range of employee salaries to consider charging back. Landlords have legions of staff who perform administrative functions such as arranging for insurance, collecting and administering rents, tracking operating costs, arranging for repairs and maintenance, and they also have executive staff who perform multiple roles such as leasing, development, management of staff and the like. Many landlords have centralized property management functions and removed the presence of on-site staff. Some landlords have both on-site staff and centralized staff, grouped by regions and functions. Take the example of an accounting team set up at a satellite office, whose function it is to manage all the accounting data relating to an entire portfolio of properties owned by a landlord. Undoubtedly, if a landlord were a single-property owner, it would include its cost of either a single accountant for the property or the costs paid to a third-party accountant to perform the accounting tasks, in Operating Costs. Likewise, a landlord of multiple properties with a group of off-site accounting staff will expect to recover an allocated share of the accounting group costs from each of its properties. But a team of accounting people may not simply record revenues and expenses. It may generate reports for investors or lenders, it may forecast cash flows, it may perform tasks in pursuit of income tax-driven strategies. How can a tenant be satisfied that not only the cost allocation is fair, but the administrative/management fee superimposed on that allocation is fair?

Reviewing the case law above, we see that the courts have no difficulty enforcing an agreement to tack fees onto expenses. The difficulty lies in getting the parties to agree on what will and will

not attract a fee. This is a matter of bargaining strength and has little or nothing to do with fairness (which lies in the eye of the beholder).

Part III – Gross Ups to Occupancy Levels

There are two main types of "gross-ups" in commercial leases. First, there is the grossing up of the "usable area" of rented premises to their "rentable area" which is achieved by pro-rating certain common areas amongst the premises available for lease. One commonly known method for that type of gross-up is embodied in the BOMA Standard Method for Measuring Floor Area[12]. Area gross ups are done for purposes of determining the area to which the annual per square foot rental rate will be applied.

Another type of gross-up, the type with which this paper is concerned, is the grossing up of Operating Costs to what they would have been had the building been fully occupied. It is common, in commercial leases, to find a clause that allows the landlord to estimate the amount of Operating Costs that would have been incurred if the building were fully occupied (or sometimes, 95-96-97% occupied), and then use that figure when determining the tenant's proportionate share of Operating Costs. Tenants often have severe reactions to these clauses when negotiating this aspect of their lease. However, these can generally be cleared up via detailed explanation and the giving of minor assurances.

Indeed, this type of gross-up is widely accepted as an industry norm because it is not necessarily unfair or abusive. It is designed to match costs with users, so that vacancies in multi-tenantable buildings do not cause the landlord to subsidize costs generated by the actual occupants/users of the building. (That is not to say that the gross-up does not have the potential for abuse.)

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[12] Published by the Building Owners and Managers Association International as an American National Standard ("ANSI"). BOMA is an international federation representing the commercial real estate industry's interests through a variety of means. The latest BOMA standard is one that was approved on June 7, 1996 by ANSI (ANSI/BOMA Z65.1-1996). Essentially, the revised Standard permits landlords to recover rent on not only the common areas of multi-tenanted floors of office buildings, but also on building common areas that provide services to building tenants. Examples of these common areas include lobbies, atrium spaces, concierge areas, security desks, conference rooms, lounges, vending areas, food service facilities, health or fitness centres, daycare facilities, locker or shower facilities, mail rooms, fire control rooms, fully enclosed courtyards outside the exterior walls and building core and service areas such as fully enclosed mechanical or equipment rooms. Excluded are parking spaces, portions of loading docks outside the building line, and major vertical penetrations (such as elevator banks).

An example would assist to clarify: if the tenant were the only user and occupant of a building that was 30% vacant, it would be unfair to require that tenant to pay only its proportionate share (based on area) of utilities and janitorial services consumed by the building. This is because, considering that there would be no other occupants consuming utilities, all utility costs would be those generated by the tenant (leaving aside any common area utility consumption). Likewise, any janitorial services provided to the tenant would be priced to the landlord to correspond with the actual space being served. If the tenant were to pay only its proportionate share of those costs, then the tenant would pay 70% of the costs that were 100% generated by the tenant, i.e. the landlord would foot the bill to the extent of 30% - of the utility and janitorial costs generated solely by the tenant! Mathematically, there are a couple of ways to avoid this result. One way is to adjust the denominator of the proportionate share fraction to ensure that the actual users of the services are included and vacant space is not. Another way is to gross-up the costs so that when the proportionate share fraction (unadjusted for vacancies) is applied to the grossed-up amount, full recovery is achieved. (A combination of these mathematical approaches may in fact be necessary to truly match costs to users.)

If the landlord were to gross up the cost actually incurred to the amount that would have been incurred had the building been fully occupied, and then calculate the tenant's proportionate share (70%), the result would be that theoretically at least, the landlord would not be stuck with a shortfall.

Following is a sample provision setting out an Operating Cost gross-up to occupancy levels:

> Notwithstanding any contrary provisions of this Lease, if, at any time during a fiscal period, the Project is not one hundred percent (100%) occupied, the Landlord shall have the right to increase those items of Operating Costs which vary with the extent of the occupancy or use of the rentable premises in the Project (including, without limitation, cleaning costs, supplies and garbage removal) to such an amount, as in the reasonable estimation of the Landlord, would have been incurred if the Project were one hundred percent (100%) occupied and operational for the entire fiscal period and the amount of such increase shall be included in the Operating Costs.

It must be acknowledged that certain Operating Costs are inappropriate for grossing-up (such as insurance, and to some extent, the cost of personnel carrying out administrative or property management functions). But a tenant who is mistrustful of the proposed gross-up wording can usually be mollified by the insertion of the following assurance into the lease, as it does reflect the intention:

> Notwithstanding the foregoing, (i) the Landlord will not gross-up Operating Costs as aforesaid if the effect thereof will be to allow the Landlord to profit by recovering more than 100% of the actual Operating Costs incurred by the Landlord, and (ii) in no event shall the Tenant have to pay on account of Operating Costs an amount higher than it would have paid had the Project been fully occupied.

As this practice has become so widely accepted in the commercial leasing industry, there are many cases where landlords implement the mechanism despite the lack of governing lease documentation explicitly allowing it. There is no known case law on point but as leases - especially cost recovery provisions – are contracts to be construed faithfully in accordance with their plain, literal wording, it is not expected that a court would permit any type of gross-up in the absence of express contractual provisions to that effect.