A Guide for Commercial Real Estate Tenants: Understanding the Variable Cost Risks of a Commercial Lease

Overview

Organizations choose to lease commercial space for a variety of reasons, including; long-term financial objectives, ability to access limited resources, questionable long-term market viability, and other considerations strategic to their individual business needs. These organizations may consider a variety of factors when evaluating a lease, including lease versus buy analyses and other financial influencers. However, organizations often fail to fully understand the financial risks associated with the leases they engage in beyond base rent factors, specifically considering additional rent expenses, such as common area maintenance charges. Depending upon the nature of the leased premises (e.g., shopping mall), these additional rent elements can exceed 50 percent of the annual base rent expenses.

An inadequate understanding of the variable cost elements within a lease is often further complicated by a significant lack of cost control capabilities by both the landlord and tenant. Through our experiences performing lease analyses for clients in a variety of industries, we find that many landlords are not equipped or staffed to manage the complexities of each lease to ensure each tenant has been billed properly, resulting in incremental occupancy costs for tenants.

Furthermore, tenants frequently are experts in their respective industries; however, they often do not possess the specialized cost control capabilities required to thoroughly review and monitor a complex portfolio of leases and additional rent cost allocations. Additionally, the departments responsible for creating the leases are rarely involved in the detailed cost control activities beyond high-level budget monitoring.

This lack of control is further exacerbated by a market with declining commercial occupancy rates and diminishing rents. Many landlords are looking for opportunities to offload facility management and capital costs normally offset by tenant contributions and rents, regardless of the terms of each lease. Often times, expenses are passed on to tenants through liberal interpretation of common area maintenance terms or similar expense allocation provisions.

Any combination of a tenant's misunderstanding of the variable cost risks of a lease, inadequate tenant and/or landlord cost controls, or quasi-ethical issues regarding landlord interpretation of lease cost allocation terms could result in unnecessary occupancy costs in which the tenant is the only party paying the penalty. In order to protect an organization from the financial risks considered above, tenants must understand the financial nature of various types of leases, the root cause of many non-compliant lease transactions, common additional rent financial risks, and risk mitigation strategies.

This guide has been designed to discuss the nature, financial risks and management considerations for recurring lease-related occupancy costs. Operational factors, accounting considerations and non-recurring transactions, such as free rent, tenant improvement allowances, and abatements are not discussed.

Nature of Leases

Typically, the most significant and easy to understand cost associated with a lease is the base rent amount. Base rents take on a variety of forms, including:

- **Fixed rent**, which is most often a fixed amount per month and often quoted as a cost per square foot within a lease. Leases with fixed rents may also require periodic rent (e.g., annual) escalations, sometimes referred to as step costs, to align with long-term inflation and rental market rate changes. These escalations may be specifically defined as a dollar or percentage increase or designed to align with a particular index, such as the Consumer Price Index.

- **Percentage rent** is a variable rent concept based upon the tenant's monthly revenue or other specific cash flow calculation. This form of rent is found almost exclusively within retail property leases and is based upon a percentage of revenues / cash flows above and beyond a specific revenue breakpoint. Or phrased differently, percentage rent is often calculated as a specific percentage of revenues or cash flows over a specific revenue or cash flow target.

- **Minimum rent** is the minimum periodic rent amount defined within a percentage rent agreement. For example, if a tenant does not meet the revenue / cash flow break point, the tenant will only owe a minimum rent amount.

For many organizations, the rent types described above are, for the most part, relatively easy to budget for or project based upon overall business performance and fixed cost considerations. However, as noted above, many organizations fail to understand the most volatile and variable rent elements, which are the expenses passed onto the tenant above and beyond the base rents amount, referred to as "additional rent expenses."

When considering commercial real estate, leases are often classified by which party pays for expenses related to the operation and ownership of a specific property. The most common additional rent expenses discussed within leases can be summarized according to the following broad categories:

Category	Expense Description
Tenant Unit Maintenance & Utilities	Expenses specifically attributable to a tenant's facility, including direct utilities, maintenance of the tenant's assets, etc.
Property Taxes	Property taxes for the parcel or land or share of occupied space that the tenant specifically occupies.
Insurance	Insurance covering the actual building that the tenant is physically occupying.
Common Area Maintenance	Costs of maintaining the areas on a particular development or property in which no tenant receives an independent benefit. For example, common area maintenance costs may include the cost of maintaining sidewalks, general parking lots, property landscaping, real estate tax and insurance specific to the common area space, and property security.
Administration / Management Fee	A fee charged as a percentage of Common Area Maintenance or other project expenses to cover General and Administrative costs.
Other	Many leases specifically define other specific expenses outside of these broad categories as additional rent allocations. For example, Heating, Ventilation and Air Conditioning (HVAC) is often identified as a specific tenant responsibility.

Considering the additional rent expenses defined above, the following common lease categories or classifications are defined below.

- **A gross lease**, sometimes referred to as a full-service lease, is a lease in which the landlord pays for all building-related expenses associated with owning and operating a property, while the tenant is only responsible to pay a base rent amount. Gross leases are rarely available in today's commercial real estate market; however, when used, this lease is most frequently associated with multi-tenant office buildings in urban areas.

- **A modified gross lease**, sometimes referred to as an industrial gross lease or a base year lease, is a lease in which the landlord pays for all expenses associated with owning and operating a property and the tenant pays a base rent; however, any increases in operating expenses above the first year, also known as the base year, are passed on to the tenant. This type of lease is most commonly used in multi-tenant office buildings and warehouses.

- **Net Leases**, also referred to as pass through leases, are leases in which the tenant pays a base rent and specific operating expenses typically associated with owning and operating a property, including utilities, repairs, insurance, and taxes. There are three types of net leases, including single net (referred to as "net"), double net (referred to as "net net") and triple net (referred to as "net net net") leases.

The following table summarizes the most common expenses associated with each of the three net lease types:

Lease Type	Rent	Tenant Unit Maintenance & Utilities	Property Taxes	Building Insurance	Common Area Maintenance
Single Net Lease	T	T	T	LL	LL
Double Net Lease	T	T	T	T	LL
Triple Net Lease	T	T	T	T	T

Legend: T - Tenant Pays LL - Landlord Pays

For each of the leases with additional rent components described above, tenants typically remit a monthly base rent payment and an additional rent payment based upon a budget established by the landlord each year. At the end of each lease year, landlords provide an additional rent reconciliation to account for any true up charges between the budget and actual expenses.

Root Cause Analysis of Non-Compliant Lease Transactions

In an effort to maximize occupancy and cash flows, landlords negotiate highly variable and complex leases which often vary from tenant to tenant within the same establishment. Similarly, many tenants have large portfolios of leases, each of which vary depending upon landlord, location, and any other influencing factors.

As discussed above, each lease may combine a variety of recurring cost allocations beyond the base rent, including common area maintenance expenses, real estate taxes, insurance, and other expenses. This high degree of variability between leases complicates both landlords' and tenants' ability to manage large portfolios of leases for financial compliance. Unfortunately, as noted in the introduction, the lack of effective financial controls by either the tenant or landlord may result in non-compliant occupancy costs in which the tenant is the only party paying the penalty.

Furthermore, ambiguous additional rent expense terms, liberal interpretations of additional rent expense terms or a misunderstanding of terms by a landlord may also result in incremental costs to tenants. Misunderstanding even subtle differences in lease terms can result in substantial cost implications. For example, consider an office building that has experienced a 15 percent year-over-year reduction in occupancy. Many of the costs associated with maintaining the facility and providing marketable enhancements are no longer being offset by rents or cost allocations. Depending on the terms within a particular lease, the landlord may allocate the full costs to current tenants based on their respective percentage of occupied square footage rather than an allocation based on total square footage. Applying an allocation based upon occupied square footage rather than total square footage results in nearly 18 percent of incremental occupancy costs for each tenant.

In addition, any lack of understanding or clarity regarding each party's specific operational and financial responsibilities in a lease can result in duplicative efforts and costs by the landlord and tenant, neglected property issues and other unnecessary expenses. For example, insurance for shopping mall properties is often covered by landlord policies. While performing a lease compliance and cost recovery review for a client recently, we found that our client had duplicative insurance coverage for over 50 properties throughout the United States, resulting in significant unnecessary occupancy costs.

Common Financial Risk Considerations

When considering strategies to mitigate lease-related financial risks, it is important to understand common risk factors influencing the broad categories of leases with variable cost elements. The following listing of potential additional rent expense risks is based upon common issues identified during additional rent and common area maintenance audits. Naturally, this listing is not intended to be a complete list of all risks as leases vary significantly from tenant to tenant and landlord to landlord. Leases typically define the types of allowable expenses, fees and other transactions. Leases also typically define transactions that may not be allocated to tenants, such as capital improvements or enhancements to a facility. As such, most leases can be assessed for risk considering these common issues and risks.

Base Year Completeness Risk: Leases in which expenses are allocated considering a base year credit, calculate annual allocations based upon the following simplified formula:

(Tenants Share of Current Year Operating Expenses) less (Base Year Credit Embedded in Monthly Rent) = Tenant Expense Share

Besides many of the risks discussed below, leases in which future expense allocations are defined based upon a base year credit carry the risk that the base year was significantly understated. Examples of potential base year understatements include: 1) base years established using costs based upon occupancy levels below normal, 2) base years established using cost estimates containing partial year costs rather than annualized costs, and 3) the addition of new services in future periods without retroactive adjustments to base year credits. Considering the formula above, any base year understatement or lack of retroactive adjustment for new services will result in incremental expense allocations in future periods.

Proportionate Share Misallocation Risk: Leases often allocate additional rent expenses, most frequently common area expenses, based upon the tenant's proportionate share of occupied space (i.e., the fraction numerator) considering either the entire premises or total of all occupied premises (i.e., the fraction denominator). For example, the following formula is typically applied to calculate an allocation:

$$\text{Total Allocable Expenses \& Costs} \times \frac{\text{Tenant Occupied Square Footage}}{\text{Total Occupied or Total Property Square Footage}} = \text{Tenant Expense Share}$$

As noted in an example earlier in this report, the misapplication of an incorrect denominator can result in a significantly different allocation of expenses.

Unsurprisingly, an incorrect numerator also can result in an inaccurate allocation of expenses. An incorrect numerator can be the result of a simple recording error, inclusion of space specifically excluded from the allocation calculation, or use of facility size estimates rather than actual square footage. For example, a restaurant organization leasing a pad of land within a shopping development may have patio space in which the expenses are not allocated; however, an erroneous allocation calculation could include the patio space within the numerator, resulting in incremental occupancy costs for the tenant.

Furthermore, leases often estimate the square footage of a leased establishment prior to construction or occupancy with the intent of applying the actual square footage once a tenant takes possession of the site. Quite frequently, the actual measurements are not considered when applying the actual allocation of expenses, which can result in either under or over billings.

Misallocation of Management Fees Risk: Landlords are often compensated for the management of a facility through a predefined percentage fee based upon expenses managed. For example, a landlord may be compensated at a rate of 3 percent of all common area maintenance fees. These fee rates can be erroneously applied at either the wrong rate or to non-operating/management expenses such as insurance and real estate taxes. Note: Leases should clearly define the management fee rate and to which expenses each fee should be applied. Some leases will apply different management fee rates for different types of expenses.

Unallowable Property Maintenance Labor Risk: In order to facilitate the management of a property, landlords will often use their own employees to perform certain services. Unallowable labor charges include services for other properties, services benefiting a specific tenant or group of tenants, undocumented labor activities and unreasonable back office activities (e.g., billing tenants) not specifically defined as allowable within the lease document.

Unauthorized Labor Rates, Labor Burden or Markup on Labor Risk: As noted above, landlords may use their own employees to manage facilities. When passing these costs onto actual tenants, these charges may include:

- Unauthorized labor rates: Labor rates that have not been formally approved within a lease or amendment that exceed actual labor costs.

- Unauthorized labor burden charges: Labor burden charges are the labor expenses above and beyond the hourly labor rates paid to employees for taxes, benefits and other labor costs (e.g., union fees). Due to the variability of tax liabilities and other benefits requirements, landlords may apply an unapproved estimated labor burden rate to all labor costs rather than passing on actual expenses as incurred. Any burden rates applied should be trued up annually to ensure costs are for actuals or align with the terms of the lease.

- Markup on labor charges: Landlords may apply an additional fee on labor charges that has not been pre-approved according to the lease. Keep in mind, in this scenario, the landlord will likely apply the overall property management fee on top of this markup, which results in a markup on a markup.

Unsubstantiated and Incorrect Amounts Billed Risk: Leases typically require that landlords provide a statement or reconciliation annually of all operating expenses showing the tenant's additional rent allocation liability. These leases also generally require the landlord be able to substantiate all transactions with supporting documentation, including invoices, labor reports and any other required documentation. Transactions lacking supporting documentation or transactions that do not agree to supporting documentation are frequently unallowable.

Real Estate Taxes Error Risk: Real estate taxes may be allocated for both a tenant's actual site and share of common area costs. The tenant's specific site tax allocation can be based upon an allocation considering square footage or the actual taxes for a sub parcel in which the tenant occupies. Common area taxes are most often allocated based upon the tenant's proportionate share of the property. Allocation errors may include the pass through of taxes for a parcel that inappropriately exceeds the size of the actual tenant's occupied space, a parcel that differs from the tenant's site or a proportionate share misallocation.

Unallowable Charges Risk: Leases often define both allowable and unallowable additional rent expenses. Unallowable expenses often include capital purchases or enhancements to the property or expenses that do not benefit the entire tenant pool.

Ambiguous Lease Term Risk: Many leases often include ambiguous definitions of common area maintenance costs within leases to maximize a landlord's ability to pass expenses to the tenant pool. For example, the following ambiguous or broad termed definition of common area costs is defined in Martin Zankel's book titled, Negotiating Commercial Real Estate Leases (101):

" 'Common Area Costs' means all sums (including "Capital Costs" as hereinafter defined and to the extent stated herein) expended by Lessor, its agents, contractors and employees for operating, maintaining, repairing, and administering of the Shopping Center including, without limitation [specific cost examples]…"

A definition of common area costs this broadly defined will theoretically allow the landlord to allocate nearly any expense they define as within reason.

Risk Mitigation Strategies

Opportunities to mitigate the risks discussed above should be viewed from three angles:

1) Prior to lease execution, evaluate opportunities to protect the tenant through balanced negotiations,

2) Prior to the payment of each lease-related expense, perform a robust and sustainable lease transaction review and approval process, and

3) On an ongoing basis, implement a risk-based audit program to evaluate landlord compliance with the financial terms of each lease.

Prior to Lease Execution: Tenants worldwide frequently execute standardized form lease documents provided by landlords without question. A lease presented by the landlord has likely been designed to protect the landlord's interests, potentially including cash optimization strategies related to passing on additional rent expenses. In fact, Valencia Mackie, in her book titled, 10 Commandments for Dealing w/ Landlords, estimates that over 90 percent of her small business clients had draft leases designed to specifically benefit the landlord.

When considering a commercial real estate lease, a tenant's ability to strongly negotiate is highly dependent upon market conditions (e.g., vacancy rates), landlord's willingness to comprise, and the tenant's potential leverage considering size and other factors. Based upon the difficulty of negotiating leases and the potential financial and operational risks a lease agreement presents, all companies should leverage the expertise of real estate lease experts, including general counsel. Additionally, large companies that maintain large portfolios of leases should consider opportunities to develop their own form lease considering their unique risk factors. At a minimum, a tenant drafted lease can be used to benchmark a landlord's form lease for negotiation purposes. Or, the landlord may agree to leverage the tenant's form lease, which ensures the tenant's concerns have already been articulated.

When negotiating leases, professional lease experts consider a variety of factors, including operational, environmental and financial risks. Unfortunately, many lease professionals fail to consider an organization's ability to manage the complexities within a lease.

For example, a growing restaurant chain may have minimal back office personnel with the experience or time to manage a portfolio of 30 – 50 leases, much less understand every lease and spend the time required to properly evaluate landlord additional rent reconciliations. An example opportunity to mitigate these risks through negotiations may include the use of an easy to manage "fixed additional rent expense with index-based escalations" clause rather than standard triple net lease expense allocation terms.

Prior to Payment Review: As noted earlier, additional rent expenses are paid on a monthly basis considering a landlord's annual estimate and trued up annually via additional rent reconciliations. To protect the organization from overpayment, organizations should review and understand proposed increases to additional rent budgets from landlords, compare each monthly payment against and the approved budgeted amounts, and perform a comprehensive review of annual additional rent reconciliations prior to payment. Each level of review should be performed by a person familiar with the specific lease and additional rent risk factors. The most complicated aspect of this review strategy is the analysis of the annual additional rent reconciliations, especially when considering organizations with large portfolios of leases. Opportunities to streamline this review process include;

- Track all leases with additional rent components to ensure additional rent reconciliations are received on a timely basis, as defined by the lease;

- Design and implement a standardized additional rent review checklist, considering common risk factors. When developing the checklist, organizations may require different levels of review for different types of leases. For example, reviews may be different based upon the materiality of transactions;

- Develop additional rent abstracts from leases for easy reference. Abstracts should also clearly identify transactions that require enhanced analyses not already defined within the standardized checklist review process;

- Prioritize additional rent review processes based upon materiality, percentage of change from prior year values and other risk factors or concerns relevant to the tenant;

- In large organizations, require all monthly and additional rent reconciliation review processes to be reviewed by someone other than the preparer to ensure the prescribed review processes have been effectively executed.

Ongoing Additional Rent Audit Program: To complement Management's review and approval process prior to payment, organizations should execute their right to audit through a rotational 1 - 3 year risk-based audit program. For example, assuming an organization has implemented the review and approval controls discussed above, an organization might consider the following:

- Fully audit the most material leases annually to ensure all additional rent transactions are allowable, fully substantiated, properly calculated and consider other risk factors relevant to each lease.

- For leases that are less than material, organizations should implement an every-other-year or every-third-year review considering the same audit steps as the annual lease audit process. By using this approach, organizations can streamline their monthly and annual pre-payment reviews to focus on the most material or relevant changes.

For example, during an annual pre-payment review of an additional rent reconciliation related to a lease that is less than material, an organization may review only the supporting documentation or reports provided by the landlord for reasonableness rather than performing a comprehensive audit. The organization would then evaluate the landlord's compliance with the terms of the lease every other year or every third year through the rotational audit program. Any landlords with compliance issues would be required to issue a credit or refund for any over billings. Additionally, the tenant would likely choose to audit this landlord annually due to known prior issues. By implementing this process, management spends less time managing small- and low-risk leases and more time managing leases based upon risk to the organization.

Note: Leases may not have specific audit clauses or rights defined or may specifically disallow a tenant's right to audit records. Landlords may interpret a lease with no specific audit rights defined to imply the tenant has no audit rights; however, through the implied covenant of good faith and fair dealing in United States contract law, all parties are believed to operate within the bounds of the lease and should be able to prove their compliance. More specifically and importantly, there is no expressed provision stating no audit rights exist and the law requires both parties to operate in compliance with the contract. As such, the landlord may be compelled to provide supporting documentation for pass through expenses through either negotiations, arbitration or other legal proceedings.

To minimize legal costs and unnecessary management efforts, tenants should work with landlords to renegotiate or amend contracts to clearly define specific audit rights.

Conclusion

Commercial real estate leases can be complex and include significant financial risks for tenants. However, organizations can mitigate these financial risks by implementing a thorough risk-based lease management strategy, including well-informed negotiations led by real estate lease experts, robust and risk-based lease transaction review and approval controls, and a risk-based additional rent audit program. As each organization differs in overall strategy, management philosophy, and management capabilities; lease management strategies will vary from organization to organization. Regardless of lease portfolio size, all organizations can benefit from considering the unique risk factors and mitigation opportunities prior to executing any lease.

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