Understanding and reviewing the 'hidden rent'

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***Rick Burke** is President of Lease Administration Solutions (LAS), a company that offers a wide range of professional lease management services. As part of LAS, Mr Burke has overseen many large-scale auditing, abstracting and lease administration projects. Prior to founding LAS 15 years ago, Mr Burke was in charge of lease administration for Beacon Properties Corporation, Boston MA, being responsible for developing and designing the lease administration department. Mr Burke also worked for retailer Marshalls Inc. for seven years, managing in turn the Lease Auditing and Lease Accounting departments. Mr Burke was also responsible for creating the lease audit function and audit collection process for The Marmaxx Group, the combination of TJ Maxx and Marshall's totalling 1,100 stores. Mr Burke has written and been quoted in many articles for national magazines and newsletters regarding lease administration, lease auditing and lease abstracting, and he is frequently asked to speak on these subjects. He has been involved with the Nation Retail Tenants Association (NRTA) since its first conference and is a chartered member. He served on the NRTA curriculum committee for 14 years and is currently a board member. He also has been an instructor on lease administration related classes at Boston University. He has degrees in accounting and management information systems from the University of Arizona and an MBA from Suffolk University, Boston MA.*

Abstract

Tenants must understand their lease before signing it. Much too often, a tenant looks back and realises they have agreed to something that is now costing them thousands of dollars per month. This paper opens the door and introduces the tenant to the many types of possible overcharges. It looks at several basic areas of overcharging and explains why they exist and how to avoid them. These areas include pro-rata share allocation, administrative charges, non-common area maintenance (CAM) expenses, real estate taxes and caps. The paper also looks at some specific overcharges related to office and industrial leases such as base year and gross-up clauses. Understanding all the ins and outs of a lease is very difficult, especially for someone not in the real estate business. As with most things, the more detailed it gets, the more complex it becomes. This is especially true for additional rents such as CAM, operating expenses, real estate taxes, insurance and other monetary lease items. These items, if not fully understood, will become 'hidden rent'.

Keywords: lease auditing, lease administration, occupancy cost, operating cost, lease abstracting, lease audit, hidden rent, common area maintenance

The lease was negotiated and signed a year ago, the billings from the landlord are coming in and the tenant realises that what was budgeted for rent and additional rent is much lower than the billed amount. It begs the question: 'why?' The most likely answer lies in the additional rent components of the

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lease such as common area maintenance (CAM), real estate taxes and insurance (also known as CTI). For a tenant in an office building these items are called *operating expenses*. These expenses have been dubbed by many as the 'hidden rent'. Over the years, billing additional rent to tenants has become much more aggressive. An obvious reason for this in the last several years has been the economy. Landlords looking for additional revenue to survive in a downturn economy often turn to additional rents as a potential profit centre. The creation of real estate investment trusts (REITS) also has put pressure on the landlord to produce more revenue for its shareholders. Another reason is the lack of legal consequences or penalties in the lease for deliberately overbilling a tenant. Thus, it has become the tenant's responsibility to review these billings to avoid overpaying.

The lease language dictates what a tenant is responsible for paying, and the leverage the tenant has when negotiating the lease dictates the lease language; however, no matter what shape the deal takes, every tenant should incorporate a thorough review of their CAM or operating expense reconciliations. In the commercial real estate industry, this is called the *desk-top review* and it can achieve significant savings for a tenant. The desk-top review is designed to catch the overcharges before the tenant pays them. This is important, especially for a tenant with smaller square footage, because it is much harder to collect the overcharges once they have been paid.

Another form of reviewing the CAM or operating expense statement is via the lease audit. The lease audit is most often performed after the tenant has paid the overcharges, and is generally much deeper in scope. Lease audits are usually conducted by third parties that specialise in lease auditing. Again, like the desk-top review, lease audits can provide significant monetary savings to the bottom line. Following is a review of areas of overcharging frequently identified by tenants during a desk-top review.

COMMONLY IDENTIFIED OVERCHARGES

Pro-rata share

The first item to review is the basic calculation of the tenant's *pro-rata* share. The *pro-rata* share is the percentage of expenses shared by the tenant for expenses incurred for the shopping centre or office building. In most leases, the *pro-rata* share is calculated as a fraction of the tenant's square footage divided by the total leasable square footage of the shopping centre or building. Tenants should be aware that their lease may state *leased square footage* versus *leasable square footage*. If it is the former, the reviewer must now verify all tenant vacancies and move-in dates because only the leased tenants will contribute to the tenant's allocation of expenses. A tenant should never agree to gross leased and occupied square footage (GLOA) as the denominator when negotiating a lease — it should always be gross leased area (GLA) — because GLOA is much too difficult to verify and provides opportunities for mistakes or overcharges. The tenant's square footage (numerator) is easy to verify in their lease; however, verifying the shopping centre or building square footage (denominator) may be more difficult. Asking the landlord for a tenant roster with square footage listed is common when verifying the *pro-rata* share. A tenant in an office building having a base year should only be paying their *pro-rata* share of costs over the base-year amount in any year. If the base year is a result of the first year's actual costs, then it is important to review the base year to determine what items are included, because the base year will be used to determine the cost paid every year going forward.

Now, assuming that the retail lease does not allow for anchor contributions, the tenant should be done verifying the square

footage that determines their *pro-rata* share. But if the lease allows for anchor contributions, the tenant will need to verify the anchor's square footage that is deducted, and determine if the anchor or major contributions being deducted from the billing are fair. This is done by comparing the cost per square foot of the anchor contribution deduction with the cost per square foot of what the tenant is paying and deciding how big a variance they can live with. Understanding the definition of an *anchor* or *major* in the lease is also very important in verifying the calculation because many leases will define the anchor or major by the amount of square footage.

Administrative charges

Most commercial retail leases allow for a 5–15 per cent administrative charge on expenses to cover the landlord's administrative cost for the common area. If an administrative cost is included, in addition to the administrative fee, then the cost should be disallowed. During the desk-top review, a general ledger of invoices is requested to identify these administrative costs and then these are disallowed. In addition, administrative fees are not always applied to all expenses. Accounts such as insurance, real estate taxes and utilities may not be subject to an administrative fee. In these cases, the reviewer would just disallow the applied fee on these accounts.

Management fees

A common overcharge to office tenants is the management fee. Unlike administrative costs, most management fees are calculated based on 2–5 per cent of gross revenue of the building. The first step a tenant should take when reviewing is to refer to the lease to verify if they are required to pay a management fee. Not every lease requires the tenant to do so and the language regarding management fees may be silent. In this case, the tenant is not responsible for such a fee. In addition, there are different methods of calculating a management fee. Some calculate it as a percentage of gross revenue, others use gross revenue less pass-through costs. In some cases, the author has seen landlords include investment income as part of the revenue from the building. Because a management fee is a pure profit to the landlord, the tenant should always request back-up documentation as well as the method of calculation before paying a management fee.

Non-CAM expenses

Many expenses are dictated by the lease language that allows or excludes such expenses. The reviewer will need to read the lease carefully to understand which expenses can be billed to the tenant. Some of the more common excluded items are expenses relating to building, structure, roof, capital expenses, initial construction, specific tenants and landlord professional fees. In addition, if the lease states 'expenses for operating, managing and repairing the *common area*', instead of the *shopping centre*, certain expenses related to areas other than the common area may be disallowed.

Real estate tax

Real estate taxes have long been an area where a tenant can expect to find overcharges. But, until recently, the review process was long and cumbersome due to the lack of availability of information. In today's dynamic environment, however, reviewing real estate taxes has become much simpler. Today, this information is made much more available due to the increased access of online documents provided by county tax assessors, tax collectors and the deed of records. Quite often, information such as tax maps, property record cards and assessment values can be found by simply searching for the tax assessor's website for that city or county.

Initially, the reviewer should check to see if the tenant is paying for the correct tax parcel. This is easy to do by going to the tax

assessor's website or calling the tax assessor and getting a tax map (also called a *tax plot plan*). By comparing the parcel numbers on the tax bill with the tax map, the reviewer can determine if the taxes are being billed correctly. A *pro-rata* share review as described above for CAM also should be performed on the real estate taxes if the tax *pro-rata* share differs from the CAM *pro-rata* share.

Another area within the real estate taxes review comprise abatements (refunds) received by the landlord for the location resulting from a challenge of the assessed value. Sometimes these abatements do not get passed through to the tenant. The situation can be verified by calling the tax assessor and asking if there has been any abatement on a particular parcel for the shopping centre or building.

Lastly, depending on the lease, late fees or interest charges to the tax collector may not be an allowable expense. These can be detected by comparing the tax collector's amount on its website to the amount billed to the tenant.

Caps

Tenants often feel that they do not have to worry about their CAM or operating expenses because they are capped as per the lease. But they should think twice because there are many ways in which a tenant can be overbilled with a cap. The tenant's protection in some cases is less with a cap than without a cap because often a review is not performed. For example, if the lease states that, in the first year of the term, the tenant's cost is *not to exceed* US$4 per square foot and will increase by 5 per cent annually thereafter, without realising it, the landlord often will charge the tenant US$4 per square foot in the first year, even if the actual cost is less. This ripples through the entire term of the lease, with the tenant being overcharged thousands of dollars. If the lease does not have a stated monetary amount, then the tenant should review the first year because the entire term of the lease will be affected by it.

Base year

Many retail leases are 'triple net', meaning the tenant pays its share of CIT in addition to base rent. In office leases, however, it is very common to have a base-year lease. This is often called a *modified net lease*. In a modified net lease, the tenant pays its *pro-rata* share of the amount over the base-year amount. The base year is often the actual cost of the operating expenses relating to the first year of the term or renewal term. In other situations, it can be a stated or negotiated amount that is also called a *base stop*. A base year or stop is treated the same in the first year as it is assumed to be included as part of the negotiated base rent; however, in subsequent years after the first year of the term the tenant only pays its *pro-rata* share of the operating cost over the base-year or stop amount. Because the higher the base amount the less the tenant pays, it is in the landlord's best interest to have a low base year for a tenant, especially if it is a large tenant. Accordingly, it is very important for the tenant to review or audit the base-year amount because it will be part of the tenant's cost calculation in subsequent years.

There are several areas in which a tenant is exposed to possible overcharges with a base-year lease. The first and most obvious area is where the base year is understated, which can happen if the landlord does not report all the expenses in the base year. During audits, it is often found that large expenses that should have been expensed off in November of the base year are held off until the following year. This creates a double overcharge to the tenant. Not only do they not get credit for it in the base year, but they end up paying their share of the expenses in the following year. Another area of overcharging happens in the subsequent years after the base year. In subsequent years, the operating expense billing statement sent by the landlord needs to

have the same accounts as the base year. A common overcharge seen is the landlord adding new accounts such as management fees or management salaries that were not included in the original base year. The expense accounts from the base year should not change in subsequent years unless it is for an extraordinary event that could not be anticipated. Comparing the base year to subsequent years should be 'apples to apples'. If there are additional accounts in the subsequent years, these often can be disallowed and not paid by the tenant.

Gross-up

The gross-up is a method of increasing the operating expense of the building in relation to the occupancy level of the building. For example, a lease may state the following:

> If the building occupancy rate drops below 95 per cent in any one year, then the actual operating expenses as defined in the lease shall be extrapolated (grossed-up) as if the building were 95 per cent occupied.

Although this may appear a bit strange to the tenant, it does have a logical reasoning behind it. Originally, gross-up was designed to benefit both the landlord and the tenant depending on the timing and the level of occupancy of the building. For example, assuming the lease language used above, if a tenant with a base year moves into a new building with a low occupancy level, then their base year would need to be gross-up based as if it was less than the 95 per cent occupancy level. This would increase the base year for the tenant, which could benefit from it going forward in subsequent years if occupancy levels are not met. To the landlord's advantage, the gross-up clause would also benefit the landlord in subsequent years if the level of occupancy fell below 95 per cent.

It is important to understand that only variable expenses that change with the level of occupancy of the building are grossed-up. Variable expenses may include tenant utilities, cleaning, management fees if based on revenues and real estate taxes if based on the income method. Fixed expenses such as common area utilities, insurance, landscaping and snowplough would not be grossed-up.

Again, there are several ways in which a tenant may be overcharged with regards to a gross-up clause. One type of overcharging the author often sees is when the lease allows for a gross-up on subsequent years for the landlord, but does not provide a gross-up on the tenant's base year. This can become a substantial overcharge to the tenant and, primarily, it is a lease negotiation mistake. If there is a gross-up clause, it should always apply to both the base year and subsequent years.

Another common gross-up mistake is the calculation of the variable and fixed expenses. The author has seen landlords gross-up both variable and fixed expenses in subsequent years when they should only be grossing up variable expenses. In addition, when the landlord calculates the occupancy level of the building, it may be incorrect. Occupancy level is calculated based on a weighted average of occupancy for the building for that year. Knowing when a tenant moved in and moved out becomes a major part of the calculation for determining the amount of the gross-up. It is vital for the tenant to request a tenant roster with move-in and out dates to verify the calculation.

FINAL WORD

Understanding the lease is the key to an efficient and effective review. Knowledge of how to review for incorrect expenses is directly related to the amount of savings realised. Most tenants do not have the time to review these expenses in detail, so they call on companies that specialise in lease auditing to perform a review or lease audit

for them. For those tenants who want to build a review process internally within their company, there is an excellent annual educational conference for further learning organised by the National Retail Tenants Association (NRTA). The NRTA has learning tracks for both office and retail tenants. The author encourages anyone who wants to learn more to look up the NRTA,[1] or to participate in its forums and network opportunities and attend the national conference.

Reference

(1) National Retail Tenants Association (NRTA), www.retailtenants.org, for more information.