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Commercial real estate overhead has never faced more scrutiny. While today's highly agile workforce brings with it a newfound level of productivity, there are various impacts and considerations felt across a business. The C-suite is looking to cut costs by reducing the office footprint, HR is reimagining the way it attracts and retains talent, and finance, accounting and compliance are still navigating ASC 842 and IFRS 16. Despite much of this taking place in a remote setting, landlords continue to pass along expenses to operate their buildings and provide services to tenants, which

To understand where this confusion comes from and why it's important, companies will need to focus on the nexus of two realities of managing commercial real estate operating costs: **methodological inaccuracy** and **contractual complexity.**

When Estimations Fail

Methodological Inaccuracy and Erroneous Gross-up Calculations:

Almost all landlords established their 2020 estimated operating budget in 2019, before anyone was aware of COVID-19's impact. In building their 2020 budgets, the normal assumptions were that 2020 would be largely identical to 2019, save for inflation and a few anomalies. Tenants were billed monthly contributions toward these expenses based on these pre-pandemic estimates. To the extent building vacancies would have reduced the overall expense pool, landlords would have made "gross-up" adjustments to ensure the tenants still in occupancy paid their fair share of the remaining costs.

With many buildings being physically unoccupied, landlords must decide whether and/or how these adjustments should be made. Grossing-up variable expenses directly correlated with occupancy is appropriate when less space is leased in a building, thereby requiring less service. However, grossing-up may not be fair when rentable leased space remains stable, but the tenants don't physically show up to the office. These issues are difficult in a normal year; this year, they will be especially challenging for landlords in deciding how to bill their tenants, and for tenants in evaluating whether their charges are correct.

Understated 2020/2021 Base Years:

In certain metropolitan leasing markets, it is common for leases to be structured with base years (often called modified gross, or full-service gross leases). In this lease model, the rent incorporates the initial cost of operating the building in the first or

be exponentially greater than anticipated for the entire lease term. Such base year expenses and assumptions should be closely scrutinized by an experienced lease audit firm with legal, forensic accounting and building operations experts. Their input can help ensure the expense level is a fair representation of the costs necessary to operate the building for the remainder of the lease term.

Prepare for the Unexpected

Contractual Complexity: To aggravate matters, every lease in a commercial office building is individually negotiated and has unique provisions designed to specifically control for many operating expense pass-through situations. Somewhat counterintuitively, these can be quite dense and, in many cases, open to interpretation. Most landlords' operating expense billings are not reviewed by their auditors, and it is rare for a landlord to tailor these bills to the individual leases. That's why it's important for tenants to keep track of the expense pass-through clauses in their leases, and to have a tight process for reviewing and auditing these bills as they come in.

Here are a few areas where lease provisions may be at odds with landlords' responses to COVID-19, causing an increase in additional rent overcharge potential:

- **Capital Expenditures** ("CapEx") – While most leases try to clarify what type of capital improvements a tenant will, and will not, pay for, landlords do not have the resources, or the incentive, to pass through CapEx in accordance with each tenant's unique, exclusionary language. For example, while some leases commit the tenant to share in cost-saving or safety-related capital improvements, who determines the definition of a cost-saving or safety-related expenditure? Opportunistic classification of CapEx and passthrough treatment is only exacerbated when it is unplanned – such as when making building investments in response to a global pandemic.

- **Ungoverned Payroll Cost Increases and Unfurnished Services** – Building

clause, it's when and how to preserve the right to question, investigate and resolve OpEx issues. This primarily involves assessing critical deadlines on dispute notice requirements, the expiration of which is timed from the date the Operating Expense reconciliation statement is received.

The Value of Partnerships

The pandemic had a much more severe and visceral impact on commercial real estate than just making operating expenses hard to calculate. That said, the complexity following drastic occupancy and operational changes leaves tenants exposed to greater overcharge risk, thereby creating a major incentive to enhance additional rent cost controls.

A proper cost control function involves reverse engineering lease deals by applying the same level of legal, building ops, accounting and facilities management expertise used to negotiate them. This way, tenants can ensure they are capturing the broadest range of additional rent expense while positioning themselves strategically within the context of their relationships and remaining in compliance with procedural requirements. To maximize the ROI from this focus, major tenants should consider implementing dedicated technology and bringing on lease accounting professionals as their expertise is often an integral part of getting the job done.

A good partnership results in not overpaying for lease obligations and more importantly, controlling the expectations of the deal in cases where contract language is unclear or disadvantageously worded.

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