

Hidden Costs in Lease Operating Expenses

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When a tenant signs a lease, the business owner often adds up the rent payments under the lease and thinks that is the total extent of the obligation. However, there are “Operating Expenses” in every lease that are effectively additional rent to the tenant. These Operating Expenses are the taxes, damage and destruction insurance and common area maintenance expenses that the landlord incurs to maintain the building.

In an office lease, these common area maintenance expenses are extensive. They include: janitorial services; utilities of gas, water and electricity; repairs and maintenance to all of the building systems including elevator, HVAC systems, electrical and plumbing; amortizations of capital replacements for the roof, HVAC and other building systems; property management fees and reimbursements for labor—the list is virtually endless—and landlords have great liberties in most leases with what they can include in these expenses. In industrial and lab leases, the extent of these costs is more limited, generally because the tenant is maintaining the inside of their premises, versus the landlord providing for interior maintenance in an office lease.

Just to put it in perspective, the typical office building has aggregate Operating Expenses from \$.80-\$1.20 per square foot per month. The typical lab building has Operating Expenses from \$.40-\$.80 per square foot per month. For industrial space, it's less at \$.20-\$.35 per square foot per month. Relative to the lease rate you pay, it's anywhere from 30% to 50% of your total rent dollar paid. This is real money we are talking about here.

In an office lease, these Operating Expenses are part of the “full service gross” or “net of electricity” rent—they are in the math. In an industrial or lab lease, they are in addition to the “triple net” rent in the lease. Thus, office tenants are lured into a false sense of security that they don't have the exposure during the lease term for these costs that an industrial or lab tenant might. What most business owners don't realize is leases are written to provide the landlord with the ability to pass through increases in these expenses with little incentive to maintain costs. In fact, when it comes to landlords getting their costs of business operations back, leases generally allow the landlord to charge rent for their staff, their staff benefits, their management office and property management fees. This is likely the biggest area of conflict, as landlords use this broad description to pass through all of their costs of doing business to the tenants.

We have seen extensive abuse in this area where landlords are increasing the Operating Expenses over the term by passing through their increases in staff. This is done when landlords put their general administrative payroll (versus those people directly and exclusively servicing the building) into additional Operating Expenses. If they have anyone that is not directly providing services to the building in the Operating Expenses, it's tantamount to fraud. We have seen leasing personnel, regional managers and other such personnel (and their benefits and office space costs!) passed through to tenants.

Landlords also charge a property management fee of anywhere from 2%-5% of the rent as a fee to manage the building. If a tenant doesn't negotiate the fee in advance, certainly the tenant should expect fees to be on the high side of that scale. If the building is a large single-tenant building, the fee should be on the low side. For small multi-tenant and complex office buildings, the fee is generally on the higher side. However, that fee should provide the landlord adequate reimbursement for all of the management services and costs. Some landlords, like Kilroy Realty, are good on this. Others we have found are charging the management fee, and then charging again for all of the payroll and benefits of their staff, in effect more than doubling the management costs that the tenant pays. The net effect is that tenants pay more, and landlords have the technical right to make them do so.

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Some of the most disingenuous building Operating Expense reimbursements are the ones that I saw 20 years ago with then one of the largest landlords in town, Trammell Crow Company. At end of year Holiday time, they would distribute poinsettias to all of the tenants in their buildings, and then pass that cost through as an Operating Expense. That same owner would hold a tenant appreciation day with the Padres, and have a great tailgate party for 1,000 people—all reimbursed as Operating Expenses to the tenants of each project.

This is the time of year that CFO's and business owners get their annual Operating Expense statement from the building owners, or property managers. These statements are typically very brief, vague and offer few real clues as to how the landlord spent money last year. If you have ever received one of these, you can bet last year's expenses were higher than the year before, and they almost always request an increase for the upcoming year. Naturally costs go up, but are the cost increases legitimate? Is accounting consistently applied from year to year?

The finance executive for the tenant often just writes the check, as they don't know the questions to ask, or where to begin to look for inconsistencies. In response to seeing the millions of dollars of our clients' money that gets paid every year just slip through the cracks, we have responded with the creation of Hughes Marino LAS (Lease Audit Services). As we continue to seek to add value to our client's bottom line, we can get them a great lease, but now there is a new sheriff in town to provide some enforcement.

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