Key Tactics for Managing Occupancy Expenses in A Down Economy

By: Pamela V. Rothenberg and Lisa J. Ruddy*

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*Pamela V. Rothenberg, prothenberg@wcsr.com, and Lisa J. Ruddy, lruddy@wcsr.com, are members of the Real Estate Development Group at Womble Carlyle Sandridge & Rice, PLLC where they both work on a variety of commercial office and mixed-use real estate transactions and have special expertise in commercial office leases. Scott R. Hoffman, scott.hoffman@cushwake.com, a Senior Director at the Washington, D.C. office of Cushman & Wakefield, Inc., substantially contributed to this article. Scott has provided real estate advisory and financial modeling services to some of the country's most prestigious corporations, law firms, not-for-profit organizations, and trade associations in Washington, D.C. and nationally.

It is impossible to read any publication these days, in particular those focused on the real estate industry, without being bombarded by depressing economic news laced with an absence of any light at the end of what will unquestionably be a very long tunnel. Hence, we found it intriguing to stumble upon what will be, for the foreseeable future, our new favorite expression: ***"A recession is a terrible thing to waste."*** This insightful observation "spoke" to us because it suggests that there really are possibilities to pursue in the midst of the current darkness. It also implies that some type of activity is required to maximize the opportunities that may exist. Given that we are "activators," the prospect that today's challenging and turbulent economic conditions offer a chance to take some productive action strongly resonates with us.

So, how does this all relate to an in-house counsel's role in managing his or her company's occupancy expenses? Here is our view: Today's recessionary conditions offer in-house counsel a unique opportunity to add value to their organizations. These "bad times" not only permit in-house counsel to take the lead in initiating a "hard look" at their company's occupancy leases and related expenses, but also enable them to potentially have greater leverage in negotiating with their landlords for better lease terms, all towards the objective of achieving both meaningful cost savings and increased budgeting predictability.

Here are some key tactics in-house counsel should consider implementing to better manage their company's occupancy expenses:

Conduct an Internal Review of Operating Expenses.

The starting point for any effort to manage occupancy expenses is to conduct an internal and informal review of your company's lease to get a sense of the terms it contains that bear on these costs. To save on third party costs (such as those associated with a lease audit, as described below), this analysis can be performed by your company's in-house staff. The objective is to identify the expenses your company is obligated to pay under the lease and whether it is paying more than is necessary. In conducting this informal review, pay particular attention to the following terms:

- How much is your company paying in base rent and have any applicable rent escalations been calculated correctly?

- What is the square footage of the leased space and has it been measured accurately (i.e., in accordance with the measurement standard specified in the lease, if any)?

- Has the percentage of space that your company occupies relative to the square footage of the entire office building been calculated properly? This percentage (often called the tenant's "proportionate share") drives the amount of operating expenses in a triple net lease and the increases in operating expenses in a full service lease that the landlord can pass through to the tenant. For example, your company's rentable area should not include restrooms, storage areas and/or utility closets that are not used exclusively by your company. Has the square footage of the building decreased or has the building been re-measured since the lease was signed such that your company's proportionate share should be decreased?

- Closely examine the lease sections governing operating expenses and exclusions from operating expenses, and then compare those sections to the annual expense reconciliation(s) provided by the landlord. Has your company been charged for anything that is not permitted by the lease (i.e., an expense that was expressly excluded)? Were capital expenditures handled in accordance with the terms of the lease?

- Carefully review the landlord's statement of estimated operating expenses and compare it to the statement of actual expenses incurred by the landlord. Have there been any miscalculations?

- What is your company paying in utility charges each month? Is the landlord charging for any services that are not actually being provided or that your company is not entitled to use? Does the amount the landlord is charging match your company's proportionate share? (You may need to request backup information from the landlord if this information is not provided in the landlord's expense reconciliation.)

- Has the landlord inappropriately charged your company any overtime HVAC or utility charges?

- Are the landlord's operating expense costs comparable to what other landlords in the area are incurring and passing along to their tenants? (A broker can provide you with comparables.) While you may not be able to address this issue under your current lease, you should take it into account in connection with any lease renewal you are considering.

- Was your company provided a tenant improvement allowance to build out its space? If so, did your company use the full amount? Is your company entitled to receive any unused allowance, either in cash or as an offset against rent? If your company fronted any construction expenses, did the landlord reimburse these expenses as required by the lease?

- Does the lease permit your company to conduct a lease audit? Are there circumstances under which the landlord can be held responsible for the costs of the audit?

An internal operating expense review can be a means for effective management (and possibly reduction) of operating expenses at a minimal cost (i.e., without the third party costs associated with a lease audit). Further, if your internal review reveals discrepancies between the amounts that your company actually owes under the lease and the amounts that the landlord is charging, you may be able to recover these amounts at a substantial cost savings. If the results of an internal review are compelling, those findings may warrant that you take the next step and conduct a professional lease audit.

Conduct a Lease Audit.

Stated simply, a lease audit is a comprehensive and detailed review of a lease and a landlord's operating expense records, typically performed by an outside auditor, to ensure that all revenue-generating and cost reimbursement provisions of the lease are being properly interpreted, calculated and implemented by the landlord or its manager. Many errors arise because lease provisions are not being implemented properly, lease language is being misinterpreted, critical data relating to the calculation of rent or determination of operating expenses has not been entered correctly, or landlords are inaccurately calculating rent numbers or cost reimbursements. Lease audits will often reveal costs and expenses a landlord is requiring a tenant to pay that, based on the requirements of the lease, a landlord may not legitimately pass through to a tenant. Audits also often identify inadvertent mistakes in the tenant's favor that have been made in the interpretation or calculation of rent escalation and other revenue-generating lease clauses. To the extent that they reveal billing mistakes, particularly those relating to tenant overcharges, lease audits can establish a credible basis for a tenant to institute a legal claim. Before rushing in to a lease audit process, you should review the provisions of your lease to see what rights, if any, the lease offers for the tenant to conduct a lease audit and who bears the associated costs.

Carefully Evaluate Your Company's Current and Future Space Needs and Shed Unneeded Space.

Take a hard look at your company's growth projections, as well as its potential need to downsize, given today's uncertain economic conditions. Compare your findings with the amount of space that is available within your company's offices. If you determine that your company might need less space either presently or down the road, then consider consolidating multiple locations and/or shedding unneeded space through a sublease of the space or an assignment of the lease in its entirety. Depending on your specific circumstances, you may also consider requesting that the landlord, itself, recapture a portion of the premises. The landlord may impose a lease "buy-out" price for this recapture. However, in the long run, payment of that consideration may still result in overall long term cost savings when compared to the total rental and operating expense payments your company would save by eliminating the excess space.

Renegotiate Lease Terms.

This tactic will be most viable if your company is a major tenant in its building or if its lease is due to expire in the next few years. In negotiating new lease provisions, whether mid-lease term or upon a lease renewal, focus on getting those economic terms that are most favorable in the current market. An experienced broker can provide you with valuable market information that can not only give you more leverage relating to the reduction of operating expenses, but also improve on an overall basis the basic economic terms of your lease. Consider the following cost-saving ideas in negotiating a lease renewal:

- Ask the landlord to reset the base year under your company's lease to the year immediately prior to the first year of any renewal term (this will reduce your proportionate share of operating expense increases during any applicable renewal term).

- Ask the landlord to provide a refurbishment allowance to spruce up your space for the renewal period, and negotiate to achieve the right to offset against base rent any unused amount of the allowance.

- Consider "locking in" your lease renewal as early as possible in order to achieve more favorable economic terms (especially if you are operating in tenant-favored market conditions). Landlords will frequently offer a more generous business deal in exchange for a long-term lease commitment.

- Request that the landlord upgrade existing HVAC systems and/or install energy management equipment, both of which can result in significant cost savings to the building's tenants.

- If your company pays for utilities based on the rentable area of its premises, consider asking the landlord to install sub-meters that monitor and permit you to pay for electricity costs based upon your company's actual energy use.

- Ask the landlord to automatically adjust your company's proportionate share of operating expenses if the office building is re-measured or the building square footage otherwise decreases over the term of the lease.

- Consider asking the landlord to offer some of the following additional tenant-favorable terms (to the extent not already included in your company's lease): an option to contract (reduce amount of leased space); an option to terminate the lease (i.e., a lease buy out at discounted price); a right to conduct a lease audit, with a requirement that the landlord pay for the cost of the audit if your company has been overcharged by more than a specified percentage (i.e., 3-5%) in any 12-month period; a right to confirm the space measurement and core factor; favorable assignment and sublease rights; and a comprehensive list of operating expense exclusions.

Even if your company is not a major tenant or facing a lease expiration, depending on the specific facts and circumstances the landlord is facing with its own real estate portfolio, you might find that you have more negotiating leverage to achieve better lease terms than you would otherwise think. For example, if your company is experiencing economic difficulties during these trying times, you can argue that your company will be less likely to default under its lease if the landlord would agree to improved economic terms. Landlords do not necessarily like to give lease concessions or reopen negotiations on a long-term lease, but they also do not like defaulting tenants and vacant space in their buildings, particularly if the landlord is facing its own economic hardships and vacancies across its entire portfolio.

Relocate.

Another option to consider, as unpleasant as it may be, is a relocation of your company's office to new space. Although moving costs and other one-time expenses associated with a relocation may appear somewhat daunting, moving to new office space could result in long-term cost savings. New landlords will often not only offer you a very beneficial base rental rate, but they often will also take over the balance of your company's existing lease obligations. Further, even if you ultimately decide not to relocate, the mere fact that you considered that possibility (in a public way that does not go "unnoticed" by your current landlord), may result in your ability to achieve better renegotiation terms from your existing landlord upon a lease renewal. If, in fact, your company does make the decision to relocate, be sure to consider whether the new building is LEED certified, as energy efficient buildings can be more cost-effective from an operating expenses standpoint.

Request an Energy Efficiency Audit.

An energy efficiency audit can determine whether the building in which your company's office is located wastes energy. Properly conducted, such an audit can lead to utility cost savings by identifying areas of the building (including insulation, heating, lighting and equipment use) that are leading to unnecessary energy loss. Consider requesting that your landlord conduct an energy efficiency audit to identify possible opportunities to save energy costs that would benefit both the landlord and your company. Note that your local electric or gas company may offer free or discounted energy audits to their customers, or you can contact your state or local energy office to identify an auditor.

Select your Real Estate Professionals Carefully.

Finding a skilled team of professionals to assist in your lease evaluations and negotiations can have a dramatic impact on your bottom line. A commercial real estate broker with office leasing expertise can give you significant insights into the market (including availability of tenant concessions and favorable rental rates, among other things) that other, more generalized brokers may not offer. Similarly, a knowledgeable real estate attorney with experience in commercial leasing will target and negotiate critical cost drivers that will enable you to successfully manage your company's occupancy expenses and give your company the maximum amount of flexibility.

Given that real estate expenses are the second largest line item (behind salaries) on every company's financial statements (amounting to, on average, between six and ten percent of an organization's total annual revenue), and that every company is focused today on cost-cutting, few things could be more productive for a company's bottom line than employing tactics to effectively manage occupancy expenses. In-house counsel, as legal experts and business players within their companies, have a chance to play a significant and valuable role in this process.