Commercial Office Leases in the United States: Financial Risk Transfer And the Loss of Innovation

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Received (in revised form): 6th July, 2016

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Abstract

This paper focuses on the financial risks of the freehold estate which have been transferred, through evolving lease contracts, to the leasehold estate, within the context of the United States commercial office industry. This reduction of an ownership

Corporate Real Estate Journal
Vol. 6 No. 1, pp. 1–8
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2043–9148

risk has occurred without diminishing the ownership right of receiving rent. This has significantly changed the market equilibrium mechanism of estate rights and risks. As a result of this market disruption, innovation in the leasehold property sector has been retarded for decades.

Keywords: lease operating expenses, financial risk transfer, evolution of US leases, lease capital expenses, landlord enterprise risk, lease vs buy, innovation

DIFFERENT ESTATES IN PROPERTY HAVE DIFFERENT RISKS

The principal estates in property are freehold (of which, fee simple is the most commonly used type and hence practically synonymous) and leasehold, each having their respective rights and risks. The rights of a freehold estate include the right to alter or sell the property, to receive the benefit of appreciation in value, to claim tax depreciation, and to create leasehold estates and benefit from the related rent. The risks of the freehold estate include the risk of destruction and damage, of depreciation in value, and of the economic costs of owning and operating property. When the freehold estate owner uses its right to create a leasehold estate and benefit from the related rent, the owner has also, historically, retained the related financial risks of ownership. These rights and risks are theoretically held in balance.

Prudent corporate real estate management considers the rights and risks of the freehold and leasehold estates as they may support or detract from the competitive advantage of the enterprise. Enterprises that deliberately choose to take a leasehold estate in property are presumptively electing to avoid the risks, and to forgo the rights, of a freehold estate. These enterprises are demonstrating they are 'not in the real estate business' and assume that holding a leasehold estate obviates the risks of a freehold estate.

This paper will focus on several of the financial risks of the freehold estate which have been transferred, through evolving lease contracts, to the leasehold estate, within the context of the United States commercial office industry. This reduction of an ownership risk has occurred without diminishing the ownership right of receiving rent. This has significantly changed the market equilibrium mechanism of estate rights and risks. As a result of this market disruption, innovation in the leasehold property sector has been retarded for decades.

THE ALLOCATION OF FINANCIAL RISKS OF A COMMERCIAL OFFICE LEASEHOLD ESTATE IN THE UNITED STATES HAS CHANGED A GREAT DEAL TO THE BENEFIT OF THE LESSOR

Some 40 years ago, the leasehold estates defined in commercial office leases in the United States generally produced a 'fair trade' between landlord and tenant. For the landlord, its ownership rights allowed it to lease a property and benefit from rent, while it retained the financial risks of having those ownership rights. For the tenant, its leasehold rights allowed it to use a property, in exchange for the payment of rent, without taking on the risks of owning the property.

Through the late 1970s, under the terms of what was then called a 'full-service gross lease', tenants only paid what was then called 'base rent' in exchange for the rights of a leasehold interest. That rent was a benefit to the landlord, which directly flowed from its freehold estate right. The bargain then was that in exchange for having that right, the landlord had the financial responsibility for:

> Building operating expenses, which included: 1) utilities, repairs and maintenance, property management, etc.; 2) insurance premiums and deductibles; and

3) gross receipts, property and other ad valorem taxes.

Capital expenditures.

Landlord enterprise costs such as: 1) its own operational expenses; 2) marketing, advertising and leasing expenses and commissions; and 3) its debt service.

With the financial responsibility for these items, the landlord also held the financial risks. It was the commercial assumption that tenants were not in the real estate business and therefore it was commercially agreed that the risks of ownership were the sole responsibility of landlords.

Today, however, US leases have transferred many of these financial risks of ownership from landlords to tenants. These risks have been transferred incrementally over time, often in response to macroeconomic changes that impacted owners negatively. New lease clauses were carefully crafted to minimise the appearance of the risk transfer while owner entities and their agents provided artfully reasoned rationales to reduce the perception of the risk transfer.

Focus on three types of financial risk transfer in commercial office leasehold estates: Building operating expenses, Capital expenditures, and Landlord enterprise expenses

Building operating expenses

In the late 1970s when full-service gross leases were standard, rents were often escalated at stipulated rates, reflecting historic assumptions of inflation of operating costs. When inflation rates increased dramatically, for some years over 10 per cent, landlords' operating profits were eroded. Landlords saw their investment returns fall or become negative as they absorbed the increasing operating costs of ownership. Landlords responded by innovating a way to protect their returns by introducing the 'Base Year' concept into leases. This concept fixed the landlord's costs of ownership to those operating costs incurred in the first lease year (the 'Base Year', adjusted as necessary for a multitude of reasons) and *tenants pay in subsequent years for the increases in expenses over and above the Base Year amount*. Landlords thus effectively transferred the risk of inflationary increases in operating expenses to tenants. This was a simple mercenary move to 'guarantee' a baseline of profit for landlords. Initially, to reduce the impact of this innovation, landlords agreed to offset the financial risks transferred to tenants by granting multi-year periods of non-escalating rents interrupted by fixed rent increases at specific points during the lease term. After the acceptability of the innovation was broad enough, even that accommodation was removed and now tenants pay annually escalated rents AND annual increases in building operating expenses.

The next landlord innovation came with the introduction of a new type of lease called the office triple net lease (ONNN), beginning in the late 1980s. In this type of lease, *tenants pay for all operating costs without any offset such as is used in the Base Year lease.* Thus, the tenant's risk was no longer limited to inflationary increases, but had increased to how the landlord chose to manage its building. Although the landlord continued to reserve the freehold rights to define the scopes and performance standards of services, to choose its service providers, and to pay these providers as it saw fit, it now made the tenants responsible for the consequences of its exercise of these rights. During this time, it was not uncommon for ownership of a building to change hands three or four times during a ten-year term. This often resulted in tenants paying widely varying amounts under their leases, as each landlord operated the building in a different way. Some landlords increased building staff, changed management fees or the 'gross-up' calculations for variable expenses, and added building amenity services. Because the landlord's operating profit *did not vary* as operating costs increased, it had no direct financial incentive to manage these costs. Tenants which were already carrying the financial risks of operating costs in place at the beginning of their leases now began to bear the financial risks of all operating costs that might be incurred during their lease terms, including the risk that the landlord poorly managed those costs on their 'behalf'.

This landlord innovation also allowed the increased costs of freehold estates that arise from their exchanges (sales) to be transferred to leaseholders. Building sales frequently trigger a tax value reassessment of the building. Although tenants had no say in and received no benefits from the sale of a building, they were required to pay more in property taxes. This is a cost of ownership from which tenants were no longer protected.

The terms and costs for insurance within leases have also changed over the years. Most leases now require the tenant to pay for the landlord's insurance for the landlord's interest in the property, with no mutuality, as landlords explicitly are not required to insure the tenants' interests. Tenants are also obliged to contribute to the rebuilding costs under a covered event, to the extent of the uninsured costs limited by the insurance policy's deductible. But tenants are not allowed to specify the terms or limits of coverage, or even the deductible. Having burdened tenants to this extent, landlords — almost comically — also require tenants to reimburse the landlord's cost of 'loss of rents' insurance coverage.

Many markets across the United States have switched to the ONNN lease form as it transfers a majority of the financial risks of ownership to tenants. This helped create the idea of a 'rent coupon' — that a landlord's real estate enterprise was, to the greatest extent possible and primarily, a simple and predictable bond-like financial instrument, and, as little as possible and only secondarily, a complex and dynamic competitive business. Note that a similar condition holds in the United Kingdom for internal repairing leases in multi-let premises, and full repairing and insuring leases in single-let premises, but the 'bond-like' nature of the leases is enhanced by historically long lease terms, often lasting 15 or more years.

Protecting landlords from the risks of increased costs has transformed the landlord's expectations from its leasehold enterprise. Landlords now do not benefit from decreased operating costs, so they have lost their incentive to reduce those costs as a way to improve their own profit. As a result, landlord enterprises lack innovation, creativity and initiative. It has been regulation and other external incentives that have changed landlords' offerings in the property marketplace: building codes, environmental standards and direct financial incentives have replaced innovation in the industry.

It is true that landlords do continue to compete for new tenants in a market based on the 'gross' rents each charges (base rent plus operating expenses). An efficiently built and managed property will have lower operating expenses than a markedly less efficiently built and managed property. However, in a static market where landlords are not responsible for operating expenses, competition begins only when a landlord in the market takes the initiative and risks the investment to increase efficiency, with no guarantee of return (that is, a new tenant electing its building over another in the market which is less efficient). On the other hand, if all landlords in a market benefitted directly, immediately, and with full assurance from savings in operating expenses, their incentive to innovate and invest would be enhanced.

Capital expenditures

The freehold estate provides the rights to receive tax and depreciation benefits of ownership, to retain the residual asset value of the property and to be the sole beneficiary of any increase in the building's value over time. These rights were balanced against the obligations and financial risks for all costs associated with the purchase, preservation and enhancement of the property. Therefore, the cost of capital improvements, repairs, equipment and the like were excluded from building operating expenses because those capital expenditures preserved or increased the overall value of the underlying asset, which value accrued to the freehold estate. As these rights and risks were reserved for the freehold estate, leaseholders did not reimburse landlords through lease contracts any part of such capital expenditures. With this balance of rights and risks, landlords created and maintained capital reserve funds to pay for the necessary capital improvements, repairs and expenditures to own and operate their buildings.

From an accounting viewpoint, capital expenditures are those costs for goods and services which have a useful life over one year, are extraordinary, non-recurring costs and are significant in dollar amount. Thus, landlords expected to incur the cost of replacement of a roof, security system or HVAC system (among other things) at the end of the useful life of each respective item. Because one of the risks of freehold estates is that of changing legal or regulatory environments, landlords also absorbed the cost of capital expenditures required to comply with new or existing building codes or laws.

With the success landlords had transferring the financial risks of operating a property to tenants, they next turned to innovating ways to transfer to tenants the financial risks of required capital investments in a property. Three cases of this type of landlord innovation are discussed in the following sections.

Capital expenditures for government mandated improvements

In the mid-1980s, landlords started to charge tenants for certain types of capital expenditures by recharacterising them as operating expenses through an expanded lease definition of 'operating expenses' which included certain capital expenditures.

For example, landlords unilaterally argued that it was not a fair bargain that the freehold estate absorbed the cost of a capital expenditure required by newly enacted laws which were *beyond the landlord's control*. They created new bargains in creating leases that required tenants to share in the risk of new laws enacted after lease commencement. Landlords unabashedly took the position that they had no responsibility to bear the financial costs of the regulatory risks of having a freehold estate, that is, of being in their chosen line of business. Hence, the great majority of commercial real estate leases now include a definition of building operating expenses similar to:

> 'Costs of a capital nature which are incurred as a result of complying with laws, building codes, municipal ordinances or other regulations enacted after the lease commencement date, provided such expenditures are amortised over the useful life of the improvement.'

Capital expenditures for cost-saving improvements

Some capital improvements may result in a reduction of a building's operating costs, such as LED lighting or high efficiency chillers. However, due to the earlier innovation of transferring operating costs to tenants, landlords did not benefit from such a reduction; tenants only bore the burden and reaped the benefits of innovations in building technology. Landlords predictably argued that tenants who wanted a reduction of operating expenses achieved by a capital improvement were responsible for the costs of those capital expenditures. The great majority of commercial real estate leases now include a definition of building operating expenses similar to:

> 'Costs of a capital nature which are intended to produce operating cost savings to the building provided such expenditures are amortised and provided further that the annual amortisation cannot exceed the annual savings actually achieved or reasonably estimated by the Landlord.'

Capital expenditures for 'safety purposes'

In the early 2000s, another capital expenditure provision was introduced, allowing a landlord to escalate the annual amortisation of capital expenditures incurred 'to enhance or improve the safety of the building and/or its tenants'. At first glance, this seems sensible, since tenants would want the landlord to take the necessary steps to make the building 'safe'. This was another effort to atomise the costs of being a landlord and make the tenant explicitly compensate the direct costs of the landlord to run its business. Further, the use of the word 'safe' is often not clearly defined and can be vague enough to encourage a landlord to undertake a whole host of capital improvements which a tenant may not find to be related to safety at all. In practice, this can lead to landlords taking advantage of their tenants' obligation to pay such costs under the terms of their leases.

Consider the case of a landlord which renovated a building's elevator system and charged the associated cost to its tenants. The landlord argued that because the elevators were becoming unreliable and therefore 'unsafe', and with lease language which allowed the landlord to amortise capital expenditures incurred 'for safety purposes', it was justified in charging the amortised cost as recoverable lease expense. In this case, this cost amounted to more than $100,000 per year for the next seven years.

This rationale based on the 'safety' provision is too broad and opens the door for landlords to replace nearly any major building system, including air conditioning systems, roofs, building facades and parking garages. In reality, these improvements are generally required because the systems have reached the end of their useful life.

Capital expenditures for 'stability of services'

More recently, some landlords have innovated by proposing the escalation of capital expenditures which are necessary 'for the stability of services' the landlord provides at the building. For example, at the commencement of the lease a landlord is required to provide HVAC service, but after a number of years the HVAC system fails; under this rationale, the landlord can argue that the capital expenditures needed to continue to provide those services should be charged to the tenant. However, this concept is even more elastic and ambiguous than the 'safety' provision previously discussed. It is another landlord innovation, extending the scope of financial risks transferrable to the tenants. Resting on language such as this, landlords may effectively transfer all of the financial risk of replacing *any* building system or equipment which has reached the end of its useful life. Actual cases of this include $1.6 million to replace a HVAC system, $800,000 for waterproofing the building envelope (resealing the exterior glass), and $750,000 for an upgraded elevator system.

Landlord enterprise expenses

Following on their success in transferring freehold financial risks to tenants, landlords have also transferred some of the economic costs of being in the real estate business. One example is the cost of debt servicing which has traditionally been viewed as strictly an owner's cost of financing its 'inventory' for being in the property leasing business. However, a recent case[1] may have an effect on the future treatment of this category of expenditure.

In this case, the landlord purchased a building for $700,000,000 which was in excess of the value of the building when measured against other comparable buildings in the marketplace. The new landlord obtained a secured loan for $500,000,000. In order to obtain the remaining $200,000,000 of loan proceeds which exceeded the market/replacement value of the building, the new landlord had to purchase a 'lease enhancement insurance' policy (much like a private mortgage insurance fee required for a residential house if the buyer deposits less than 10 per cent). The landlord passed the $8.3 million cost of this non-cancellable, ten-year, lease enhancement policy to its tenants through operating expenses.

In response, a tenant observed that the lease stated 'any debt service under any mortgage on the Property and any financing or refinancing costs related thereto' were specifically excluded from operating expenses. The tenant argued that if the landlord had not purchased this insurance it would have been unable to obtain the loan and by carrying this coverage, was likely to reduce its borrowing costs as well. The classification of this insurance coverage as a financing cost is underscored by the fact that the policy was non-cancellable, even in the event of another sale or refinancing of the building. Therefore, it is inextricably tied to the financing and not the operation and maintenance of the building. In reality, the policy insures the $200 million of 'excess' financing of the building and not the insuring of the building itself. The tenant had to file a legal suit, arguing the lease enhancement insurance was an owner's costs of financing the building and should not have been escalated. At court, the presiding judge reviewed the lease and focused on the insurance clause. The definition of insurance which was a part of the overall operating expenses to be escalated included 'all costs of insurance required by lender'. Since the lease enhancement insurance was found to have been required by the landlord's lender, the judge dismissed the case. The tenant appealed the decision but lost the appeal on the same grounds.

This decision may set a precedent that landlords may rely on in the future to justify the escalation of certain costs of financing some types of debt service back to its tenants, even though a majority of real estate professionals would consider this an owner's investment cost. Absent the inclusion of specific lease language to the contrary, this is just another responsibility of ownership which the tenant may now have to bear.

Conclusion

In the United States, through the evolution of lease contract language, it now seems that most of the financial risks of a landlord's freehold interest have been transferred to its tenants, without a corresponding transfer of rights or benefits. Coincidentally, new United States accounting standards[2] are going into effect which will result in the recording of most real estate leases in ways similar to owned real estate assets, that is, listing them on balance sheets as an itemised 'right of use' asset and a balancing liability. If enterprises are assuming most of the risks and costs of owning real estate and have to account for property leases as if they were owners, might it make more sense to buy instead of lease? If a leasehold is the preferred estate, then the tenant should attempt to carefully negotiate all financial risk transfers, attending to precisely what the landlord is and is not able to include in expenses to the tenant. Often, however, even the largest tenants cannot negotiate separate operating expense terms than smaller but existing tenants in the same property, due to the complications, administrative work, and risk for errors created by having different cost allocating mechanisms within one building. In any case, the tenant should also scrutinise each reconciliation statement and be ready to enforce the lease when necessary.

In summary, thoughtful and effective corporate real estate leaders should consider the current allocation of financial risks between landlords and tenants. The current allocation of such risks has changed the calculus around the 'risk premium' of the fee simple estate. Lease versus buy assessments for strategic company locations may justify a 'zero-based' risk assessment that explicitly considers these risks.

Taking a broader perspective, it seems that the history of landlord innovations in transferring risks to tenants has worked to greatly reduce the generation of landlord innovations to provide better, more productive, or more efficient, properties in the commercial office marketplace. Tenants have absorbed these transferred financial risks while also taking on the primary responsibility for innovating new workplaces and infrastructure. This is contrary to tenants' intentions, by choosing a leasehold estate, to *not* be in the real estate business. Consequently, tenants in all kinds of businesses have had to also maintain some form of real estate property development business within their enterprise, otherwise known as the Corporate Real Estate department. There seems to be an opportunity for a disruptive innovation which is actually a regression to an earlier market model: landlords that retake the traditional financial risks of ownership so that they can receive the financial benefits that innovation can produce.

References

(1) SSB REALTY LLC vs AMERICAN FINANCIAL REALTY TRUST & others Court Case Number: 2010-P-0942, Commonwealth of Massachusetts Appeals Court.

(2) Financial Accounting Standards Board (FASB) 2016-02—Leases (Topic 842).