Lease Audits: Four Considerations in a Post-Coronavirus Reality

July 2020

The COVID-19 pandemic has disrupted life and business around the world, yet leases go on. When negotiating pre-pandemic leases, it is likely that you worked hard to ensure that as a tenant you received beneficial lease provisions. Now is the time to capture the full value of your negotiations. Lease auditing to ensure proper assessment of landlord charges – including examination of all lease documents and the interpretation of lease language – will be critically important going forward in a post-COVID environment, given all the ways that COVID-19 has impacted how landlords service buildings and how companies occupy space.

Nationwide stay-at-home measures to slow and prevent the spread of COVID-19 quickly forced most office occupiers to close physical locations and shift to work-from-home environments beginning in mid-March. Retail tenants were impacted further, with many not just shutting doors, but fully shutting down operations as nonessential shops were forced to halt business, and restaurants were limited to take-out or delivery services under government regulations.

In this lockdown period, NAREIT, a membership organization for real estate investment trusts (REITs) and publicly traded real estate companies, surveyed 35 equity REITs to understand how rent nonpayments and closures had affected their businesses. Industrial sector rent collection has remained fairly steady, while office collections have declined to 94%–96% of typical rent payments between April and June. Retail has fallen far more sharply down between 40–65% of normal collections in shopping center environments. Owners are facing significant rental revenue losses while many tenants are facing difficulty in meeting obligations and operating under current circumstances.

Share of Typical Rent Received in April–June

Sector	April	May	June
Industrial	99.7%	98.1%	97.8%
Apartments	89.9%	92.9%	97.5%
Office	94.3%	94.7%	95.9%
Health Care	87.3%	89.8%	95.0%
Retail			
Free Standing	72.0%	70.6%	79.4%
Shopping Center	45.9%	49.4%	60.5%

Source: NAREIT

Now into July, we are starting to see an easing of restrictions. At this point, all U.S. states are now in some phase of "reopening," varying by region and severity of coronavirus caseload. However, as of publication, some states are partially or entirely rescinding their reopening plans, due to surge in COVID-19 cases.

Employee safety and well-being currently remain the top priority for businesses, but office-using tenants are slowly preparing for a return to the workplace, with some already back in physical locations at a reduced or staggered capacity. Office building protocols and individual tenant spaces have been significantly modified to accommodate appropriate social distancing measures and limit unnecessary space sharing and interaction. Until a vaccine is widely available, nearly everything about the office environment, including office leases and future lease audits, requires new and unique considerations.

As noted, building owners have endured significant losses from rent nonpayments and vacancies during the government-enforced lockdown period. They face additional unexpected costs inherent in ensuring that their buildings are well-positioned to support distancing and other virus-control measures. Tenants should be proactive with a comprehensive lease audit plan to ensure that these expenses are not improperly passed through from landlords looking to recoup losses.

Four important lease audit factors to consider in the year to come will include:

1) **Awareness that there may be additional pressure for landlords and property managers to bill higher operating costs in order to offset lost rent revenue.** The tenant is obligated to reimburse for a proportionate share of expenses, but it will be pertinent to understand which new costs are appropriate and which ones fall under the obligation of landlords as a cost of doing business. When looking at 2020 operating expense reconciliations (likely to be issued March to June of 2021), careful evaluation will be necessary. Special attention should be given to monitoring audit window deadlines to dispute or raise questions regarding pass-through expenses and calculations. Failure to notify your landlord of concerns prior to deadline dates will eradicate your audit rights.

2) **Co-tenancy issues specific to retail tenants.** In retail leases, co-tenancy provisions ensure that a certain amount of foot traffic will be guaranteed at the leased location. They may also provide a basis for at least partial abatement of rent, should occupancy drop below agreed upon levels. With the retail sector severely impacted by lockdown measures, many retailers will be forced to close locations, and overall occupancy is likely to drop. Some leases provide for an immediate right to pay substitute/co-tenancy rent if co-tenancy occupancy thresholds are not satisfied. Further, in some cases, leases contain kick-out clauses granting the tenant early termination rights if sales drop below an agreed upon threshold. Although this has little-to-no impact on office tenants, it could impact mixed-use office building calculations. Office tenants should pay close attention to gross-up calculations and remain mindful that some retail tenants could elect not to reopen for business in existing locations.

3) **Reduction of field audit capabilities and an increase in electronic audits.** On-site lease audits are often required by landlords and can be costly to tenants due to the travel and time required. With restrictions and general guidelines against unnecessary travel, landlords won't require on-site audits in today's environment. "Desktop" audits will be more prevalent, allowing for reviews to move to an electronic environment. This will result in cost and time savings for tenants and lease audit teams but will eliminate some benefits of on-site audits, including the observation factor of physically reviewing the space and building.

4) **Trending analyses to evaluate changes in operating expenses.** Performance of trending analyses to evaluate variance in year-over-year operating expenses will be important, enhancing the need for careful inspection and reconciliation. Current circumstances are likely to result in a variance from "normal" expenses in a variety of cost areas.

   - Repair and maintenance (R&M) costs should flatline or decrease, but you are sure to see added expense categories as it has been incumbent on landlords to make property modifications that will allow their tenants to return safely to the office. Additionally, given that most offices, malls and shopping centers have been empty for the past three months, landlords may have used this time to perform capital improvement projects (roofs, parking lots, HVAC systems, etc.). Auditors should take a close look at the R&M and capital expense line items to confirm calculations for amortization schedules and caps, as well as to verify replacement versus repair language that may prohibit capital project pass-throughs.

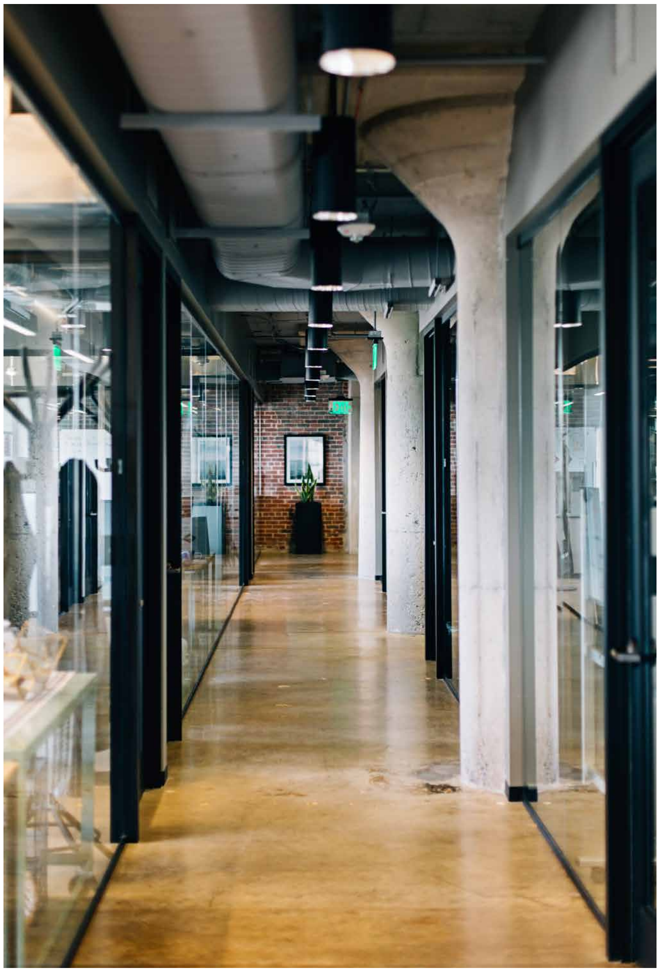
   - Janitorial expenses may increase as more frequent and deeper cleaning measures will be required to ensure that buildings and spaces are meeting safety standards. However, there should also be a corresponding decrease in the day-to-day office cleaning, trash pickup and routine work orders.

   - Utilities and electricity consumption will decrease due to vacancies and overtime HVAC expenses will be eliminated during out-of-office period(s).

   - Security costs will also likely increase as a result of building vacancies and enforcement of federal and state-mandated regulations.

- New expense line items for the cost of personal protection equipment for building personnel to be able to perform their jobs safely will need to be closely reviewed and this expense category evaluated as there will be no one-to-one corresponding base year expense.

Trending analyses of these factors can provide tenants with a deeper dive on costs and can highlight what expenses may be too high or low on reconciliation. It is also important to note that leases with a 2020 base year should be audited to identify expense outliers specifically resulting from COVID-19 to insure an appropriate base year calculation is applied for the life of the lease term in compliance with the original intent of the parties.



With information changing daily around what is expected as a return to "normalcy" occurs, the information outlined above is ultimately a prediction of how COVID-19 will impact lease audits going forward. Being aware of which current and potential items will require a thoughtful evaluation will keep tenants informed and better-positioned to reconcile landlord pass-throughs due to the COVID-19 environment.

By Ann Duncan

Click here to view author's profile.