

This Week in Real Estate: Commercial Leases — Base Year Lease

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This Week in Real Estate continues its discussion on Leases. This week we'll remain our focus on commercial leasing and discuss the base year commercial lease.

In a base year lease, a base year is selected (usually the first year of the lease). The landlord agrees to pay the property's expenses (Real Estate Taxes, Insurance and CAM) for the base year. The landlord continues to pay the property expenses at the base year level and the tenant agrees to pay its pro rata share of any increases in property expenses in excess of the amount of the base year. For example, if the property expenses for the base year (say 2020) are \$100,000 and the expenses increase to \$150,000 for the year 2021, a tenant with 20% of the square footage (or its pro rata share is 20%) would pay \$10,000 (20% of the \$50,000 increase) in 2021 in addition to the tenant's base rent (with a NNN lease, the tenant would pay its pro rata share of the entire \$150,000 in 2021 or \$30,000 in addition to the base rent). Each year thereafter, the tenant pays its pro rata share of the property's expenses but only to the extent that those expenses exceed the \$100,000 established in the base year. In most cases, the annual increase in expenses is estimated at the start of each year and tenants pay monthly to spread out the cost over the year. In the above example, if at the beginning of 2021 the landlord over-estimated the increase in property expenses at \$60,000, the tenant would pay monthly payments of \$1,000 (20% of \$60,000 divided by 12 months) totaling \$12,000. The tenant thus overpays \$2,000. At the end of 2021, the landlord would perform an expense reconciliation resulting in the extra \$2,000 being credited back to the tenant.

When presented with a base year lease, Tenants should take steps to minimize the uncertainty of their share of future expenses. First, ensure that the base year calculation is accurate. Landlords shouldn't be reluctant to review their calculations with prospective tenants. Second, ask for historical data and trends to see how expenses have increased over time. This gives tenants a reasonable basis from which to anticipate future expenses. Tenants that move into a commercial space after the first of the year should ask for 12 months of base year protection guaranteeing 12 months of tenancy before expenses become due. Larger landlords are typically more amenable to this request. Tenants should also consider asking for a cap on operating expenses. Most landlords will be reluctant. However, it's worth asking for as there are certain circumstances that can result in significant unanticipated expenses associated with remodels, improvements and/or tax reassessments after the sale or transfer of ownership of the property.

Tenants and landlords should be careful when negotiation gross-up provisions in base year leases. With gross-up provisions, landlords calculate tenants' pro rata share of variable expenses (expenses that vary with occupancy) based on 95% or 100% occupancy allowing landlords to recoup their actual expenses from existing tenants when occupancy is low. In base year leases, tenants need to ensure that the gross up provisions apply to the base year as well as succeeding years to avoid significant increases in expenses when occupancy levels rise after the base year. Otherwise, if the base year is one with less than full occupancy, tenants will be responsible for the expenses associated with full occupancy later (increases in expenses due to new tenants). As long as the base year is included, tenants with base year leases benefit from gross-up provisions. To

avoid future conflict, the lease should specifically identify which expenses will be variable and which will be fixed. Finally, tenants should seek audit rights to ensure that expenses are accurately determined and that landlords are only being reimbursed for actual expenses.

So long as landlords accurately account for expenses, base year leases are advantageous to both landlords and tenants. Tenants' burden for common expenses is limited to increases over the base year level and landlords maintain revenue stability.