

The Metropolitan Corporate Counsel

www.metrocorpcounsel.com

Volume 13, No. 4

© 2005 The Metropolitan Corporate Counsel, Inc.

April 2005

Controlling Rental Costs Through Lease Audits

**Ted Zangari
and Alan DiSciullo**

**SILLS CUMMIS EPSTEIN
& GROSS P.C.**

Many corporate tenants have taken advantage of high vacancy rates and a sluggish economy in recent years to “recast” their existing leases for extended periods at lower rental rates. And many businesses operating within company-owned real estate have sold those properties at recent market highs, entering into “sale-leaseback” arrangements pursuant to which they cash-out their equity position and become a tenant of the purchaser.

Now, with another round of corporate budget tightening apparently under way, business executives are examining their recurring expenses with greater scrutiny than ever before. One group of often overlooked expenses relate to a corporate tenant’s rental obligations under its leases for office, warehouse and industrial premises. The source of savings? Lease audits.

Corporate tenants are increasingly auditing their landlords’ books and records in order to determine the actual pass-through expenses legitimately incurred and the correct amounts due pursuant to the terms of the lease. Expenses that an owner is allowed to recoup from its tenant are very broadly spelled out in the rent provision of a lease under “additional rent” and include items such as utility charges, real estate taxes and operating expenses.

While utility charges (when based on metered usage) and real estate taxes are fairly straight-forward pass-throughs of third party expenses which can be relatively easy for tenants to verify, “operating expenses” are another story.

Ted Zangari is a Member of and Alan DiSciullo is Of Counsel to the Real Estate Practice Group at the law firm of Silks Cummis Epstein & Gross P.C. in Newark, New Jersey.



**Ted
Zangari**



**Alan
DiSciullo**

Operating expenses are broadly construed to mean an owner’s actual out-of-pocket expenses relating to the operation and management of the property, as well as the maintenance, repair and replacement of its component parts, and typically include wages and salaries, cleaning costs, insurance premiums, real estate taxes (if not separately charged), utility costs pertaining to the public portions of the property, and general accounting and legal fees. Most landlord lease forms take a “kitchen sink” approach, utilizing an “including without limitation” set of examples of various operating expenses, and the burden is on the tenant during lease negotiations to delineate those items that should be expressly excluded from operating expenses. As a result, the question of what constitutes an operating expense has always been muddled.

After 9/11, the significant monetary expenditures pertaining to upgraded building security systems further complicated the issue of what is a necessary or legitimate operating expense. Common questions have arisen as to whether screening devices, exterior pylons, grate protectors and security cameras are permissible operating costs or excluded capital expenses, and whether the cost of additional security personnel is a valid pass-through expenditure. Similarly, there has been an exponential rise in insurance premiums on commercial real estate since 9/11. The increases in these costs generally find their way into an operating cost invoice, leading tenants to also question whether terrorism insurance is a proper landlord expenditure on behalf of its tenants regardless of price.

The best method to establish rights to con-

duct an audit of an owner’s books and records is generally found in a clause in the lease which permits such activity. These clauses typically come with a list of conditions including: a limited time period following receipt of an invoice from the owner within which to contest the invoice (usually much shorter in duration than the statutory period for limitation of actions on contractual matters), a limitation on who can conduct the audit on the tenant’s behalf, and a requirement that the tenant pay the owner’s costs and fees attributable to the audit. While these negotiated provisions may limit the time, place and manner of the tenant auditing process, the audit clause itself at least establishes the tenant’s right to conduct an audit.

Absent a clear audit provision in the lease, some states still allow a tenant access to its owner’s books and records pertaining to pass-through expenses, under the covenant of good faith and fair dealing implied in commercial contracts, on the rationale that tenants must have the ability to verify the accuracy of any monetary obligation based upon the other party’s actually incurred expenses (as distinguished from fixed or flat rent charges that are not pegged to actual expenditures). Moreover, when the lease is silent as to how many years after receipt of an invoice a tenant can audit, the tenant’s audit right would normally be limited to the statute of limitations for that state.

Although the failure of a lease to address a tenant’s right to audit the landlord’s books and records is not necessarily grounds for denial of such a right, it is certainly helpful and advisable to establish the right, as well as the ground rules for such an audit, in the lease document.

Who Will Conduct the Audit? Although some ground rules must be set for the audit (i.e., reasonable advance notice to the owner, conducted only during normal business hours, etc.), the right itself should not be unduly restricted. To that end, the tenant should resist owner attempts to prohibit audits conducted by contingency-based firms or to require the use of a certified public accountant. Instead, the lease clause should permit the tenant to utilize its in-house financial team or to select an outside consulting or auditing firm to conduct the audit pursuant to any compensation arrangement

Please email the authors at tzangari@sillscummis.com or adisciullo@sillscummis.com with questions about this article.

acceptable to the tenant and the firm.

When Shall the Audit Be Performed? The lease clause should address details pertaining to the timing, frequency and duration of audits. It should also describe the time frames and mechanisms to request an examination, perform the review, dispute the charges and settle any claims.

Some landlords get tenants to agree that if the tenant does not notify the landlord of its intention to audit within thirty days of receipt of the year-end reconciliation statement, then the reconciliation is considered final and binding on both parties. The tenant should require a longer "look back" period in which to audit prior years' expense records (including "base year" records, if applicable). It may be more efficient for a tenant to audit once every three years with respect to the entire three year period rather than once annually. Although the owner wants closure, it is ultimately more convenient for the owner to deal with the tenant's auditor once every three years instead of every year. Also, a longer audit window may well result in fewer audits for an owner to deal with because its tenant will not be confronted with an annual "use or lose" deadline and may therefore elect to give landlord the benefit of the doubt and defer questioning a line item expenditure pending the determination of the same line item amount in the following year's statement.

The tenant should also resist any effort to limit the duration of its access to the landlord's books and records (e.g., one eight hour day for each year being audited) because the time required to conduct an audit depends on the condition of the books and records as well as the level of the landlord's cooperation. In addition, the tenant should establish in the lease documents its right to photocopy expense records examined during the course of an audit.

Where Shall the Audit Take Place? The lease should specify where the audit will be conducted (i.e., at the building or at the landlord's home offices). A far away audit location can be a significant obstacle for the corporate tenant executive who may have to justify to colleagues his or her expenditure on travel and lodging expenses (not to mention time out of the office) in pursuit of uncertain billing overcharges.

Who Should Pay for the Cost of the Audit? The tenant should seek reimbursement from the landlord of the costs of the audit if the landlord's errors exceed 2-5% of the amount of expenses paid by the tenant during the period of time covered by the audit. The tenant should also consider adding language that will allow disputes with the landlord to be resolved through arbitration instead of the more costly and lengthy process of litigation.

The following is a sample audit provision which may be incorporated into a lease:

Audit By Tenant

(a) Promptly following the end of each Lease Year, Landlord shall deliver to Tenant a statement in reasonable detail showing the major expense categories of Building Operating Costs, the calculations performed to determine the Building Operating Costs in accordance with the applicable provisions of the Lease, the total Building Operating Costs for the Building and all adjustments corresponding to the requirements as set forth herein, and the calculation of Tenant's Pro Rata Share of Building Operating Costs setting forth the ratio of Premises rentable square feet to Building rentable square feet (including the average Building occupancy for such year).

(b) Landlord shall utilize, and cause to be utilized, accounting records and procedures for each Lease Year (or other applicable accounting period) conforming to generally accepted accounting principles, consistently applied, with respect to all of the Building Operating Costs and other additional rent payable by Tenant hereunder, in order to facilitate Tenant's audit or inspection, as more fully set forth below. Landlord shall be obligated to keep such books and records for all Lease Years (or other applicable accounting periods) associated with this Lease until two (2) years following the termination of the Lease, including any Lease Year (or other applicable accounting period) prior to Landlord's ownership of the Building.

(c) Tenant shall have the right, at its own cost and expense (without requirement that Tenant pay Landlord's costs of complying with this provision), to audit or inspect Landlord's detailed books and records with respect to Building Operating Costs, as well as all other additional rent payable by Tenant pursuant to the Lease, for any Lease Year (or other applicable accounting period utilized herein), not to exceed one time for each such Lease Year or other applicable accounting period. Within fifteen (15) business days of Tenant's written notice to Landlord of its desire to review Landlord's books and records, Landlord shall forward to Tenant or Tenant's authorized representative, full and complete copies of the Building's general ledger, all escalation worksheets and their supporting documentation for each Lease Year (or other applicable accounting period) being reviewed. General ledgers shall be the type printed from Landlord's particular computerized accounting system reflecting: (1) the full year's listing of expenses with such expenses of course listed under its applicable account (which account has its name and number clearly specified) and with each account's expenses summarized via account balances, (2) for each expense, the date of the expense, the payee/vendor, the amount (including debits and credits), and the transaction description (reflecting an explanation of what the expense was for), and (3) the various income accounts indicating the income items

which were received and applied during the year. If after the review of such documentation, Tenant desires to perform a complete audit of Landlord's books and records, Tenant shall give Landlord not less than ten (10) business days prior written notice of its intention to conduct any such audit. Landlord shall cooperate with Tenant during the course of such audit, making all pertinent records available to Tenant, Tenant's employees and agents for inspection during normal business hours in Landlord's Building management office. Landlord agrees to make such personnel available to Tenant as is reasonably necessary for Tenant, Tenant's employees and agents, to conduct such audit. Tenant, Tenant's employees and agents shall be entitled to make photostatic copies of such records, provided Tenant bears the expense of such copying, and further provided that Tenant keeps such copies in a confidential manner and does not show or distribute such copies to any other third party.

(d) The results of such audit, as reasonably determined by both parties, shall be binding upon Landlord and Tenant. If such audit discloses that the amount paid by Tenant as Tenant's Pro Rata Share of Building Operating Costs, or of other additional rental payable pursuant to the Lease, has been overstated by more than three percent (3%), then, in addition to immediately repaying such overpayment and associated interest to Tenant (retroactive to the date of overpayment by Tenant), Landlord shall also pay the reasonable costs incurred by Tenant in connection with such audit (which costs shall not exceed the amount repaid or credited to Tenant).

Conclusion

Lease audit clauses are among the most complicated clauses in a commercial lease and the process lends itself to a specialized expertise for lawyers and CPAs. Drafting the audit clause itself requires a high degree of sophistication since the typical boiler plate clause attempts to modify many statutory and common law rights.

The audit process requires a skilled and experienced accountant who can pick up the errors in an invoice and explain these mistakes clearly to both landlord and tenant. The best solution for all parties is to have these issues resolved in a mutual settlement rather than going through protracted litigation which can have uncertain results for both parties. A protracted lawsuit can also drain the potential savings uncovered in an audit.

The law on lease audits and the field itself is still evolving. Each matter has the potential for setting legal precedent. Overall, more lease auditing issues are developing as a greater number of expenses are more closely scrutinized and challenged. However, having the right to audit in the lease is just the beginning. Gathering all the data necessary to check the escalation figures is the real challenge.