What Are Good Lease Audit Candidates?

For many commercial tenants rent is their second largest operating expense exceeded only by personnel costs. A tenant's lease provides audit rights to inspect and review the landlord's financial documentation for operating expense and real estate tax escalations related to their lease. Auditing of the landlord's expenses will provide confidence to the tenant that they are being properly billed. So, should all tenants audit their lease expenses annually? The answer is probably no. However, below are some occasions when auditing the lease expenses may be a prudent business decision.

Base-year Audit – The Base-year audit is the **single most important audit** that any tenant can have performed. The audit provides two valuable end products to a tenant. First, it properly establishes base-year expenses since all future expenses will be compared to the base-year numbers when determining the tenant's yearly liability of their share of the annual operating expenses. Second, it provides documented proof of how base-year expenses were determined. This is extremely important since in the event of a building sale, a new landlord often times will calculate expenses differently than the previous one, potentially causing a tenant to incur greater expense than prescribed in the lease.

While base-year audits are extremely valuable to all tenants, base year audits for tenants with leases in new or redeveloped buildings can yield even significantly more value to tenants for two reasons. First, these types of buildings often have high vacancy levels and landlords tend to understate base-year expenses due to the improper "gross-up" of expenses (see "High Vacancy" below about this concept). Second, these buildings often have warranties in place, post-construction, and as a result landlords do not incur normal maintenance costs for building systems such as elevators and heating and cooling systems during the warranty periods. In both instances, landlords may understate the base-year expenses, which in turn triggers an overpayment of operating escalations by tenants for all lease years subsequent to the base-year.

Large Leases –Numerous factors determine the optimal size for a lease which might be audited. Typically, any "gross" lease in excess of 25,000 square feet or any "net" lease greater than 10,000 square feet should be reviewed annually to determine if a detailed audit is advisable. Why would a "gross" lease of 25,000 square feet and a "net" lease of 10,000 square feet be equal audit candidates? This is because a "gross" lease has a base-year amount equal to the actual expenses for a given period of time, such as calendar year 2008, whereas a net-lease has in effect a base-year amount of $0. The effect of this is that if a tenant has a gross lease and a landlord consistently includes an expense in operating expenses, which should not be included, the tenant has only been harmed by its pro-rata share of the increase in this expense over what it was in the base-year amount. However, a tenant with a net lease is harmed by its pro-rata share of the **entire** expense amount since the base-year amount is $0. Even a relatively small error can lead to substantial savings for tenants of these sizes.

Mixed-Use Properties – Landlords of mixed-use properties, which include components such as office space, retail space, residences, parking garages, theatres, supermarkets, etc. routinely overcharge tenants for operating expenses and real estate taxes. This occurs because the landlord is allocating expenses to the various components of the complex using methods which don't reflect the actual usage of services by each component. In more extreme cases landlords will actually be reimbursed more than they actually expended for these services. In cases such as this the expression "the sum of the parts is greater than the whole" is not uncommon.

Building Sale/New Landlord –When a building is going to be sold, prior to the sale the seller may expend substantial sums of money for deferred maintenance in an effort to reduce any pricing adjustments a buyer would seek. Often these expenditures are capital in nature and although not permitted by the tenant's lease the landlord will pass these through to the tenants as operating expenses. Also, the new landlord will tend to have new ideas about how to run a building. It is not uncommon for them to use more aggressive methods for determining the operating expenses as they attempt to work the margins in an effort to enhance their investment yields.

Large Increase in Operating Expenses – Substantial operating expense increases often signals that a landlord has improperly calculated the expenses. A tenant should look at specific line items of expense when reviewing the year-to-year increases. For just one example, if electric expense grew by 20% and cleaning expense increased by 9%, the tenant should be more wary of the growth in cleaning expense since it typically tracks with CPI growth rates.

Major Capital Expenditures/Repairs – Buildings in which landlords have expended major capital on building systems, exteriors or common areas certainly should be considered as an audit target. While landlords may attempt to pass through these expenditures to tenants, each individual lease dictates if such capital expenditures are permissible. Typical leases only permit landlords to amortize capital expenditures which i) are required by a law which comes into effect subsequent to the lease commencement date, or ii) result in reducing actual operating expenses.

Final Lease Years – An audit performed within the final two years of the lease expiration may provide several benefits. First, overcharges by the landlord may be identified and reimbursed to the tenant. Second, by uncovering any such overcharges, a tenant will be better prepared to negotiate their next lease, either at the existing location or elsewhere, to include protective language related to landlord overcharges and stronger audit rights.

High Vacancy – The gross-up of expenses is addressed in most leases and if applied properly is fair to both the tenant and the landlord. Typically, if a building has an average occupancy of less than 95%, a landlord is entitled to adjust certain expenses which vary with occupancy (cleaning contract, cleaning supplies, trash removal, water & sewer, management fees) as if the building were 95% occupied. If applied correctly, it provides protection to both landlords and tenants. However, when a building has high vacancy, a landlord can make significant errors when applying this gross-up adjustment which negatively impact a tenant's share of the annual operating expenses, resulting in the tenant paying too much.

Tenant Vacated Premises– It is not uncommon for large tenants to negotiate new leases in multiple locations and buildings. Consequently, tenants will legitimately pay rent and expense escalations in locations from which they have vacated and do not even occupy. In such cases, landlords frequently continue to charge tenants for services that tenants do not require or receive such as cleaning services, cleaning supplies, water & sewer and rubbish removal. While most leases do not permit the landlord to continue charging the tenant for these services, landlords seldom stop this practice, resulting in needless operating expense charges being paid by a tenant.

Conclusion - A tenant should conduct its own due diligence regarding expenses related to its leased space, prior to and during the lease term. Limitations in time, personnel and fiscal resources are things that tenants often state as reasons for not diligently pursuing their rights under a lease. However, it is vital that tenants hold landlords accountable, making sure that specific terms of the lease, as well as the spirit of the lease, are being followed. A preliminary review of a tenant's lease and operating expenses helps to reveal whether or not an audit is even advisable. If an audit is done it may save a tenant substantial sums of money over their lease term.