

Lease Audits: Shakedown or Vigilante Justice?

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Lease audit firms are moving into the Colorado real estate market and finding low-hanging fruit.

As a result, landlords are increasingly being hit with tenant claims, often in the six-figure range, for transgressions of lease agreements, many of which are unintentional.

These claims range from rent abatement stemming from exaggerated rentable areas in leases to refund of expense pass-throughs based upon costs that were incorrectly figured, booked or allocated.

Business as Usual?

In their advertising, lease audit companies assert that landlords are used to being hit with such claims as a normal course of business. Although they are becoming more common, lease audits are definitely not an activity that is welcomed by a landlord, any more than an IRS audit is welcomed by taxpayers.

Dealing with a lease audit can be disruptive and expensive for a landlord. Those who do not have well-written lease agreements and well-organized documentation of expenses and area calculations will be the most impacted by the time and cost of a lease audit. Those who have good tenant communications and well-organized documentation in anticipation of a lease audit will be much less impacted when an audit occurs.

What gives rise to lease audits? In leases that give the landlord the right to pass through operating expense increases in excess of a base year or expense stop, the bills tenants receive have been increasing quickly in recent years. This is due to sharply higher security costs, insurance premiums and real estate taxes.

Tenants may not understand these increases - especially if they are not well-explained - and may suspect a landlord of overly aggressive accounting practices. This is particularly true if a tenant suspects that a landlord is under financial pressures due to current high vacancy rates or other events that are public information.

Also, seeing others who have successfully cut their occupancy expenses using lease audits has emboldened tenants to do likewise. Because occupancy costs are typically their second biggest expense, some companies now regularly audit their leases as a matter of fiscal responsibility to partners or shareholders.

No Risk

The “no-risk” proposition of lease audit firms is another factor in their popularity. Tenants may engage the services of leasing experts with only the promise of sharing any recovery with the lease audit firm.

This does not mean the lease audit firm will work for free. Most lease audit agreements include a provision for hourly or daily compensation in the event that the tenant chooses not to recover excess charges that the audit uncovers.

Thus, even when a tenant might prefer to negotiate a settlement with a landlord, they can be stuck with a big bill to pay. This is a strong motivator for a tenant to aggressively pursue collection of all discrepancies identified by the auditor.

Lease auditors also love to characterize landlords and their agents as aggressive to the point of being unethical. An ad in a local business journal pictured a shark with the caption “Don’t become your landlord’s next meal!” - with the implication that the poor tenant needs to bolster their forces to countervail against the rich landlord’s army of consultants.

While it is true that most tenants are not in the business of regularly “doing deals” in real estate and can benefit from professional representation both during and after lease negotiations, it is probably inaccurate to imply that all landlords knowingly take advantage of inexperienced tenants. A key reason for this is the potential liability and disruption that can occur in the event of a lease audit.

Another is that good tenant relationships and long-term tenant retention are based upon trust and good communications. Mistakes happen – some favoring both landlord and tenant - in endeavors as complicated as leasing. But these shouldn't become an obstacle to good relationships as long as a level of trust and a sense of fair dealing is maintained. Especially in the current “tenant market”, landlords know that good tenant relationships are an essential ingredient to keeping their buildings full and profitable.

Lease Agreements

The first line of defense against a lease audit is a well-drafted lease agreement. Leases that do not address the audit rights of a tenant leave the door open to an audit through contract law covenants of good faith and fair dealing, but they don't control how an audit will be performed.

Lease terms that restrict tenant audit rights are difficult to negotiate in today's tenant market. It is usually best to spell out tenant audit rights in the lease and provide for an agreed framework for conducting the audit. If a measurement standard is cited in the lease, it must be unambiguous.

Rentable area computed under the current (1996) version of the BOMA Standard will vary significantly from that figured under previous versions. The common term “Modified BOMA” by itself only serves as a red flag to tenants that the landlord might be greedy. While it is perfectly legal to use a non-BOMA measurement standard, the standard used must be well-drafted to avoid misinterpretation and should be available to the tenant.

Documentation

The second line of defense against a lease audit is full and open documentation. The year-end bill for pass-through expenses should be accompanied by a detailed reconciliation showing all relevant building expenses with an explanation of the factors underlying changes from the previous year and of how the tenant's bill was figured.

If a tenant has questions about some expenses, it is best to answer them straightforwardly and provide any requested back-up whether or not the tenant has a right to audit under their lease. Hiding information using legal gobbledegook only increases suspicion and the likelihood of a tenant's engaging a lease auditor.

Rentable area calculations effect not only base rent but also the tenant's pro-rata share of operating costs. However, good documentation of those calculations is often overlooked. The standard letter from the architect stating a rentable area for a suite does not meet today's needs.

Graphic Information

Tenants and their consultants want to see a graphical portrayal of the boundaries of their premises, the rentable area of the building, and the areas of spaces designated as floor and building common areas that they pay for along with the other tenants in the building. Information about the math used to allocate common areas, often contained in spreadsheets, is also necessary.

Common sense dictates that landlords should maintain documentation of area calculations in their own files, but it is amazing how often this information - if it was ever formally documented - gets dead-filed with the architect's project records and ultimately destroyed after the statutes of repose and limitation have passed (currently 7 years from the date on the certificate of occupancy in Colorado).

With the universality of Adobe Acrobat for exchanging images and data on computers, it is convenient and cost-effective, even for a landlord lacking in-house CAD software, to maintain graphical information along with the spreadsheets showing how area calculations were done.

If a tenant retains an auditor, the auditor has probably reviewed the lease and believes an audit is allowed. At that point, a landlord's objective should be to keep the matter from escalating into a law suit. A reality check of the lease, accounting practices and floor area measurement practices may be in order if it has not been previously undertaken.

The motivation to settle is evidenced by that fact that none of the matters raised in Colorado has yet gone to trial. The implications of a public trial awarding a tenant a large sum including legal fees are the biggest hammer in the lease auditor's toolbox, and a private and confidential settlement has advantages for all parties.

The Audit

During an audit, an attitude of openness and cooperation will go a long way in reducing suspicion. A landlord should channel all communication with the auditor through a single person but should have the staff and files available to that person to respond to an auditor's reasonable demands for information, including the bookkeeper, accountant, attorney (if one was employed to draft the lease), broker, and those responsible for floor area measurements. Settlements are most frequently by way of credits reducing current and future tenant expenses or base rent payments.

In summary, from the point of view of a landlord with ambiguous lease language and disorganized documentation of expenses and area calculations, a lease audit may indeed seem like a shakedown.

Lease auditors will exploit each arguable point in their audit in favor of their client. Tenants that are successful in extracting a large settlement may also feel justified in their actions even though they often create an adversarial relationship that can lead to a tenant eventually looking elsewhere for space. Many lease audits are conducted at the end of a lease for this reason.

Such is the nature of vigilante justice. However, landlords who are prepared with good documentation of expenses and area calculations, and who have good relationships with their tenants, will be the least impacted economically by lease audits, and may be in the best position to maximize long-run returns to their owners and investors.

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