

Controlling Rental Costs Through Lease Audits

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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 relates 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 to determine the actual pass-through expenses legitimately incurred and the correct amount due pursuant to their leases. Expenses an owner is allowed to recoup from its tenants are broadly described in the 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 bills an owner receives from third parties, and can be easily verified by tenants, "operating expenses" are another story.

Operating expenses are broadly defined as an owner's actual out-of-pocket expenses relating to property management and building operation, and includes maintenance, repair and replacement of various parts of the building as well as wages and salaries, cleaning costs, insurance premiums, real estate taxes (if not separately charged), common area utility costs, 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. The burden is on the tenant during lease negotiations to exclude from operating expenses those items it considers as the owner's cost of doing business. Subsequently, what constitutes an operating expense has always been muddled.

For example, after Sept. 11, 2001, significant building security system expenditures led tenants to question whether screening devices, security cameras and the like are

permissible operating costs or excluded capital expenses, and whether the cost of additional security personnel is a valid pass-through expense.

The best method to establish a tenant's right to conduct an audit of an owner's books and records is generally found in a lease clause permitting such activity. These clauses come with a list of conditions including:

- Limitations on the time following receipt of an owner's invoice within which to contest the invoice (usually much shorter in duration than the statutory period for limitation of actions on contractual matters);
- Limitations on who can conduct the audit for the tenant, and requirements that the tenant pay the owner's costs attributable to the audit. While these negotiated provisions may limit the tenant's auditing process, the clauses at least establish the tenant's undisputed audit right.

Absent a clear clause in the lease, some states still allow a tenant access to the owner's books and records, under the covenant of good faith and fair dealing implied in commercial contracts. But, when the lease is silent about tenant's rights, the audit right is normally limited to that state's statute of limitations.

The audit clause should address the tenant's right to conduct the audit. Although some ground rules must be set for the audit, the right itself should not be unduly restricted. The lease clause should also address details pertaining to the audit procedure, such as the mechanisms for requesting examinations, performing reviews, disputing charges and settling claims. Parties should also consider adding language that would allow disputes to be resolved through arbitration rather than more costly and lengthy litigation.

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