

## Know Your Rights as a Tenant

**W**ith 2005 behind us, most landlords and property managers are preparing year-end operating expense and real estate tax reconciliation statements. As soon as these statements are sent out, a time clock begins ticking and your opportunity to verify the expenses passing through to your organization elapses. For those not familiar with the history of the audit clause and its inclusion into today's commercial leases, the following will be important. For those familiar with it, there may be some additional insights to assist you in dealing with your landlord(s).

As operating expenses began to rise, savvy businesses (i.e., tenants) began to realize that what was originally presented as an additional rent obligation may in fact be flawed. Because of this, they began to initiate reviews of these expenses to ensure compliance with leases they had signed years before. In many cases, overcharges were identified and refunds and/or credits were issued by landlords.

As the volume of these analyses grew, so did the amount of time and efforts required on the part of landlords to retrieve old files and information to substantiate expenses that were passed through to their tenants. In the early years, many cases required that landlords retrieve data dating back five to 10 years. This was typically a time-consuming and arduous task for landlords due largely to the supporting documents usually being stored off-site, not properly archived for easy retrieval. In many cases, the information required was simply non-existent.

To offset this, landlords began to include specific language in leases to minimize the number of years a tenant would be permitted to audit, thereby reducing the number of years and amount of information landlords would be required to justify. In most early cases, tenants would agree that it was fair to put a limit on the number of years a landlord would be required to justify under audit.

For those tenants over the past 7-10 years that were either not savvy enough or didn't engage diligent representation during their lease negotiations, they have been duped into signing leases limiting their rights to audit far beyond what was originally intended by audit language. Many of the clauses existing today provide greater benefit and protection for the landlord than what was originally intended to create a fair and level playing field for both tenant and landlord.

The lease audit provision is meant to provide guidelines a tenant must follow to be permitted to verify and account for additional rent obligations passed through. In many cases these conditions may even give time restrictions and designate the location of a potential analysis. In some cases these provisions may even instruct the tenant as to what type of audit firm they are allowed to use (i.e., contingency-based versus time and materials billing).

Through audit clauses, landlords will try to shelter supporting documentation of additional rents billed or reconciled on an annual basis. The audit window establishes a set period in which the tenant, if it so chooses, can challenge the validity of expenses presented on the landlord's annual operating expense and real estate tax reconciliations.

If the authenticity of these expenses necessitates validation, and if the tenant does not act within the imposed time period, many landlords will use this to get out of their responsibility to produce the back-up documentation, thus abandoning their fiduciary responsibilities to the tenant. Common thought here is if the books and billings of the

landlord are accurate, why should expiration of the time requirement really matter, especially since many records needed to audit are in electronic form?

Even where the tenant has actually met the time requirements stipulated by its lease and during their review identifies expenses requiring further detailed analysis outside of the audit period (i.e., base year), the tenant will receive little or no cooperation from the landlord. The hypocrisy is that landlords will



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stick to this one paragraph (i.e., the “audit clause”) in order to avoid discussing disputed issues even when other paragraphs within the lease permit such discussions.

Many landlords will simply refuse to discuss these issues, deeming them to be irrelevant and not within the scope of the current audit. Does this seem reasonable? The simple answer is no. You have the right to audit every number shown on your landlord’s annual operating expense and real estate tax reconciliations.

In looking at your lease or any contractual obligation, you should regard it as having two separate and distinct segments. The first could be described as the “legal segment,” while the second could be described as the “economic segment.”

The legal segment contains scores of detail about what could happen if the tenant doesn’t pay rent, what happens if the building is blown away by a hurricane and all sorts of other topics that have very little to do with the financial impact of the lease on your organization. The economic segment, usually a small part of the lease, contains the actual financial components, including negotiated matters such as term of the lease, rent and rent escalations, taxes, operating expenses, and the tenant’s right to review expenses. Within these basic categories there will exist several variations, issues that make up the “spirit of the lease” that can and do become distorted over time

Distortion and/or misinterpretation of lease clauses is a common issue attributable to many factors. Property management is a business, and is subject to the same pitfalls and vulnerabilities that we all face day-to-day.

Issues like employee turnover can open the door to problems—if the person who negotiated the lease and/or monitored the application of its terms is no longer with the firm, who’s to say the new person is as diligent or knowledgeable about your lease as his/her predecessor? Competitive bidding by rival firms can mean multiple property managers in a single lease term, each of which has their own way of doing business. Most property management firms manage multiple properties for several landlords, having to reconcile expenditures for numerous tenants.

It is important to look at the semantics. The fact is, the landlord may have several buildings, and within each there may be several tenants with their own distinct leases. Every tenant negotiates a lease suiting their needs, and because of these issues, in many cases all the tenants in a building or portfolio become blended together in an expense pool, treated and billed exactly the same.

However, in each of these leases the common elements are the landlord and its financials. The simple fact is that it would be a daunting task for the landlord to have a separate set of books to track each and every lease obligation. It’s not to say there aren’t those who don’t do this, but the fact is that it is not always done. Because of this, mistakes can and often are made.

The question becomes, how often are those mistakes found, and when they are found, are landlords and/or property managers disclosing these mistakes? It is simply not something that is readily done—this is not just in real estate, but also in any contractual relationship. It’s a matter of simply doing a risk assessment (i.e., risk versus reward). Ask yourself, how often has your landlord or supplier called you to give you back money mistakenly overcharged? Property management is complex, and it makes sense to verify your leasehold/contractual

obligations. There are too many things that can do go wrong.

The relationship between landlord and tenant is, in many respects, a partnership. The landlord needs tenants to earn his profits; the tenant needs space to operate their business. To maintain the sensitivity of this relationship, both parties must be secure in the fact that what was initially agreed to has remained intact. If your lease contains additional rent obligations, these charges should be verified and confirmed.

## Part II: The Lease Audit

Is it an audit issue or is it an issue of compliance? The analyses of the economic components of a lease are broken down into two distinct elements—the actual audit of the pass-through obligations and a review of lease compliance, both of which are significant and subject to error. The audit of pass-through expenses (referred to as a lease audit) is the systematic review of documentation provided by a landlord to support its billing of expenses to tenants of a particular building. For example, if expenses contain specifically excluded items such as tenant specific charges, an audit would reveal such items and have them excluded from the amount billed.

The compliance side involves actual application of the terms of the lease. For example, if the lease states that all property or special taxes on property shall be included in your base year taxes and during the course of the audit it is determined that a jurisdiction also bills Business Incentive District (BID) taxes and those were not included in your base as computed, the landlord is required to retroactively adjust your real estate tax base and apply this revised base to all years to correct the landlord’s mistaken over-billings.

This is considered a compliance issue not subject to restrictions of the lease audit inasmuch as this has nothing to do with the landlord having to retrieve documents. This is strictly a case of an expense not properly included in your tax base each year and therefore an error exists in this one item and can easily be identified and corrected without requiring a complete audit. Compliance issues should never be confused with audit issues, and should definitely never be subject to an audit clause. Keep in mind that, typically, the only limitations on contract compliance reviews are the statute of limitations on contracts (six years in New Jersey).

When a discrepancy is identified it should be addressed immediately. Often, the process for receiving repayment of the overcharge is spelled out in detail in the lease. In many instances, the refund may even include interest that can be charged back to the landlord. The overcharge can be refunded as credits, future concessions or cash settlement.

It is important to consider the relationships involved when commencing a lease audit. However, it is equally important to ensure that this relationship does not cloud the intent of the audit—to ensure proper compliance with the financial obligations of your lease.

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