Mind

Advice on designing lease audits that harness lost revenue and promote positive tenant relations

by Pamela V. Rothenberg and Lisa J. Ruddy

Often the first thought that comes to mind when a **landlord** or **property manager** hears the words **"lease audit"** is a tenant-initiated, contentious and protracted lease review process that **raises blood pressure** and **heart rates.** While lease audits can be extremely costly and jeopardize an otherwise **good landlord-tenant relationship,** landlords and managers should **consider taking another look** at the practice, which cannot only generate **meaningful revenue** and **significant cost recoveries,** but also provide a **proactive tool** to avoid potential conflicts with tenants.

What Does a Lease Audit Identify?

Stated simply, a landlord lease audit is a comprehensive and detailed review of the leases used in connection with the commercial office, retail or industrial properties in a portfolio. Lease audits are typically performed on the landlord's behalf by an outside auditor to ensure all revenue-generating and cost reimbursement provisions of the leases are properly interpreted, calculated and implemented by the landlord or its manager. Lease audits will often reveal costs and expenses a landlord is paying, which, based on the requirements of the lease, could legitimately be passed through to tenants. Audits often identify inadvertent mistakes made in the interpretation or calculation of rent escalation and other revenue-generating lease clauses. Essentially, a lease audit enables landlords to maximize the revenue stream from rental assets by not only ensuring all rent payment clauses are being adhered to, but also by confirming all eligible expenses are passed through to tenants.

To the extent they reveal billing mistakes, particularly tenant overcharges, lease audits can also enable landlords to correct existing errors in advance of any claims by tenants. This approach allows landlords to avoid potentially costly litigation, as well as unanticipated tenant reimbursement obligations for what can often be significant dollar amounts that can decimate an asset's annual budget. From a forward-looking perspective, lease audits permit landlords to implement practices and procedures designed to target errors and ensure such errors are not perpetuated, essentially preventing tenant overcharges before they happen.

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Why Perform an Audit?

Given the complexity of most commercial lease agreements, it is not surprising they present a number of opportunities for potential errors. Jeffrey Strauss, a principal at New Jersey-based Schonbraun Safris McCann Bekritsky & Co., heads the firm's national lease audit practice and frequently finds a variety of mistakes through the landlord lease audits he conducts. According to Strauss, many errors arise because lease provisions are not properly implemented, lease language is misinterpreted, critical data relating to the calculation of rent or determination of operating expenses are incorrectly entered or landlords inaccurately calculate rent numbers or cost reimbursements.

By working with a landlord to develop a complete understanding of the operations of the building, auditors can help to ensure the landlord's lease form permits otherwise missing expenses to be recouped.

Which Clauses Need to be Reviewed?

Any lease audit conducted for the benefit of the landlord should examine each and every clause in the lease that bears on the calculation of rent to be paid or expenses to be reimbursed by a tenant. The most obvious revenue-generating lease provisions relate to the calculation of base rent and percentage rent, including the determination of breakpoints. Clauses relating to rent escalations, particularly those tied to increases in the Consumer Price Index or other cost-of-living increases (as opposed to fixed annual percentage increases), are also worthy of review, as are the determination of renewal rental rates upon extension of a lease term and the method for determining a landlord's share in any sublease profits or lease assignment payments.

Because so many expense reimbursement provisions are typically included in a lease, Strauss recommends landlords and managers use an experienced auditor to review the calculations for each and every expense provision, especially those relating to operating expenses passed to tenants for a triple net lease, or operating expense increases for a full-service lease (specifically, the proper calculation of "base year" expenses). These expenses often include common area maintenance charges, utility usage and charges, insurance premiums and other insurance costs, real estate and other taxes and the inclusion of certain permitted depreciation and amortization expenses (such as the cost of new or replacement equipment). Lease "gross-up" clauses also provide a fertile ground for calculation errors, especially miscalculations as to what comprises an appropriate and equitable base year.

When Should a Landlord Conduct an Audit?

Landlords should consider undertaking a lease audit when buying or selling an asset or changing property management companies. Because the purchase price for an asset is typically tied to a capitalization of the asset's net operating income, performing a lease audit to capture any revenue or expense reimbursements left on the table can often have a material benefit on the income generated by the asset, positively affecting pricing. Similarly, lease audits should be included among the typical due diligence activities performed by a prospective purchaser of an asset to confirm the valuation is consistent with the revenue the asset is purported to generate, as well as following settlement of property acquisitions or delivery of newly constructed assets. An audit after a change in property management or accounting firms will facilitate the integration of accurate lease data into the property management database and enhance the likelihood leases will be properly interpreted and implemented from the outset.

What Services Can a Lease Audit Include?

Lease audits involve a step-by-step process that ensures a thorough review and analysis of all lease-related billings for compliance with the terms and conditions of the lease. Consequently, an auditor should review each of the tenant leases, amendments, modifications and pertinent correspondence from the landlord. The landlord's books and records relating to the rental asset, specifically including common area maintenance and other operating expenses, tax billings, general ledgers, Argus models, leases, rent rolls and all annual statements, reconciliations and assessments provided to tenants should also be examined. The auditor should also review all data and data input and make sure that the data correspond to the terms of the lease. Once the audit is complete, the auditor will likely prepare a final report identifying total savings for the project and a schedule of possible follow-up activities required to ensure the savings are fully realized.

Lease audits can go beyond billing and expense verification and provide landlords with a variety of other services, such as lease abstracting, in which key lease clauses (e.g., the basic business points of the lease, critical dates, revenue and expense provisions and other material tenant rights and obligations) are summarized in a concise manner for easy referral by the landlord.

A lease auditor can also look at the landlord's standard leases and make certain recommendations to improve the form lease, specifically with respect to the provisions that are customarily the subjects of tenant lease audits. By working with a landlord to develop a complete understanding of the operations of the building, auditors can help to ensure the landlord's lease form permits otherwise missing expenses to be recouped.

In addition, auditors can assist a landlord in determining whether the form lease being used contains the most advantageous clauses. A perfect case study is the typical lease clause concerning the calculation of rentable area. An experienced auditor will determine if a tenant audit or remeasurement of the premises could reveal a discrepancy in the actual number of square feet leased to the tenant compared to the number set forth in the lease. If a tenant were to find a differential, the

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tenant would be likely to demand cash reimbursement of all allegedly overpaid rent and expenses for the expired portion of the lease. For the landlord, this could lead to costly litigation, a significant payment to the tenant or both. Spread among numerous tenants and leases, the aggregate effect of improperly measured areas could be financially devastating.

The auditor can work with the landlord to minimize such concerns, and the auditor would likely recommend that the lease clauses addressing the measurement of the premises should use words such as "approximately" when indicating the square footage, contain a waiver of tenant claims for unintentional measurement errors and require the tenant to object to the landlord's measurement calculations within a certain time after taking possession (or otherwise acknowledge its agreement with the landlord's calculation). A lease should also include associated landlord rights to amend the rentable area of the premises during the term of the lease, should the initial determination be inaccurate.

Lease auditors should also counsel landlords to include survival clauses to ensure lease provisions governing rent payment and expense reimbursement will survive the expiration or early termination of a lease and permit a landlord to pursue dollars left on the table even after the lease is no longer in effect. Provisions limiting tenant audit rights are also critical, because a tenant audit could result in disputes regarding alleged overcharges and subsequent demands for cash reimbursement. Landlords should attempt to limit tenants' audit rights by using time constraints to shorten the statute of limitations and restrictions on when and by whom the audit may be performed.

Who Should Perform a Lease Audit?

While lease audits may be conducted by the property management firm overseeing the landlord's buildings, such firms typically do not have the accounting or legal expertise or time to thoroughly and independently examine and evaluate a lease portfolio. As a result, landlords should consider retaining outside, independent auditors focusing on the commercial real estate industry who are knowledgeable about local customs and practices. The right audit firm should have, at a minimum, an accounting and finance background, as well as experienced professionals with a proven track record of performance and results in conducting audits for the specific type of asset that will be the subject of the review. The auditor must also only represent landlords, not tenants, in its audit practice. In retaining an audit firm, landlords should obtain detailed information about the auditor's fee structure, which is typically based on either an hourly rate or contingent fee basis, and should insist the audit firm will keep all information divulged through the process strictly confidential.

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Landlords may potentially recognize significant financial benefits through a lease audit while fostering tenant goodwill, establishing an honest reputation in the community and maintaining a positive, mutually beneficial relationship with tenants. □

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