

Lease Audit Rights: Effective Drafting and Exercise

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What are lease audit rights? In most leases, a tenant is obligated to pay for a share of building operating expenses, taxes, utilities and other costs in addition to base rent. As in any other business transaction, common practice dictates that there should be an opportunity for an accounting of charges before someone makes a payment. Audit rights in a lease affect that opportunity.

Lease audit rights are a significant part of the lease and many times are overlooked or even considered a throw-away. If not negotiated properly, audit rights in a lease actually limit the tenant's opportunity to review the landlord's books and records and can be a costly mistake that will last the entire lease term. In

those cases where a lease is silent on a tenant's right to audit, it is understood that good faith and fair dealings are the implied covenants in recognized contract law that allows a tenant the right to audit. It is important to set up fair ground rules to perform an audit. As a practical matter, a landlord will not want to keep books and records available indefinitely to be repeatedly reviewed. There are perfectly legitimate business considerations for putting some limitations on the audit of expenses, but they should be part of the lease negotiation. After all, anything less than an open right to audit represents a concession by the tenant, and as such the tenant should get value in return.

In most cases, those who negotiate the lease are not the ones who administer it,

and this can lead to misinterpretations and errors in calculations causing overcharges. If a tenant gives up the right to audit expenses, they are relying solely on the landlord's interpretation of how rent and operating expenses should be billed. No reasonable business person would allow a service provider an unfettered license to invoice for their services without the ability to review the components of that charge.

Since starting a lease audit program at some of TDS Telecommunications' more high-profile locations, we have been cognizant of tightening up the language regarding audits to ensure proper, complete reviews. It's important to the company to ensure it doesn't give up the ability to monitor expenses and correct errors.



Time Factors

Time is a crucial factor of a lease audit clause. Missing the deadline to conduct an audit can cost you the right to audit those expenses. Even if incorrect, rent

and expense charges can become binding if the audit is not completed within the agreed-upon timeframe. The following are timing issues to consider when negotiating your lease audit rights:

- How long after receipt of an invoice does the tenant have to notify the landlord of their intent to audit?
- How long after receipt of a tenant's notice does the landlord have to produce its books and records for review?
- What is the amount of time books and records are available to the tenant for review and possible objection?
- How much time will be given to complete the audit?

The above items will vary based on the staff available to do the audit work and their level of knowledge in that area. Of course, a tenant is going to want more time for review, and a landlord is likely going to want to limit the time. One alternative to consider is to audit more than one year's worth of expenses at a time to limit the amount of time committed by both parties.

What to Audit?

Any expense being passed through to the

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tenant from the landlord should be made available for review during an audit.

➤ Books and records of the landlord as they relate to operating expenses should be open to review.

➤ Invoices in support of books and records including service contracts and management agreements provide necessary support for expenses that may be invoiced by landlords.

➤ Tax returns may not be necessary, but real estate taxes should be audited.

Because of variations in leases, the above items are only guidelines and expenses that can or should be audited. Generally anything paid or payable by a tenant or billed or billable by landlords should be subject to review.

Who Should Perform the Audit and Where?

With the availability to transfer documents and data electronically, there normally is no need to travel. In fact, including a provision in the lease that the audit be done at the leased property or the landlord's office is a condition that should be taken seriously, as it is generally not necessary for the proper completion of an audit and can involve additional expenses that should be avoided.

Some landlords may try to restrict the tenant with respect to who they can use to perform the audit.

Practically speaking, many tenants don't have the manpower or expertise to conduct in-depth audits with in-house personnel, and the use of an outside firm is common. The lease should not limit the tenant's options of a service provider, such as "a CPA Firm of recognized regional standing or an auditor approved by landlord." If the tenant would not allow the landlord to dictate which attorney or broker they can use, why would they allow a landlord to approve or limit their choices of an

auditor? Firms that specialize in lease audits should be considered as they are generally better equipped to analyze the nuances involved in a lease and associated financial requirements.

The lease should also not dictate how the tenant pays for the audit. Language such as "no contingency fee auditors" is very limiting and can be costly for the tenant. Landlords may contend that

There is little downside risk to hiring a contingency fee auditor, as they provide the expertise and resources to ensure landlords are billing properly. If the auditor finds the landlord is billing properly, it costs the tenant nothing, and the landlord is aware the tenant is paying attention.

Other Considerations

If apparent errors and unsupported charges make it clear that an audit is necessary, there should be some culpability on the landlord's part for inadequate billing practices.

If errors exceed a certain percentage (2 to 5 percent) of the expenses, the landlord should agree to pay the cost of the audit. Additionally, the cost of an audit should not exceed the amount of the over-billed charges. In addition, if the parties cannot agree on the audit results, there should be a mechanism built into the lease to resolve the dispute.

Strategic Use of Audit Rights

Exercising one's audit rights could be advantageous to both the tenant and landlord when trying to "get the deal right."

Often questions arise as to the exact nature and cost of landlord services and building costs. An audit of expenses can create a better understanding of those issues

between the parties. This is particularly helpful at the beginning of a lease term when base-year expenses may be a critical element of establishing fair rent. Audit findings, in addition to setting the record straight, can also help to facilitate other leasing activities.

The parties can agree to an audit to set base year, expense stop or expense cap amounts, as well as potential effects of vacancies of variable expense elements. A thorough audit will create a mutual understanding and thus

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"contingency fee" auditors are more aggressive with a tendency to pursue less legitimate issues. In fact, the opposite is probably true. Why would a contingency-based firm go after claims that are not legitimate, when in the end they would not get paid for their effort? The tenant not using a contingency auditor by the landlord is more likely because of the fact that a tenant is less inclined to pay the cost of engaging a fee-based auditor and therefore reduces the likelihood of an audit.

diminish the likelihood of disputes over these items in the future. When the time comes for renewal or buy-out, an audit will determine whether a proper accounting of rent and expenses has occurred up to that time. Any discrepancies can be resolved and incorporated into the transaction.

Finally, if an outside audit firm is used, it is critical that they recognize and respect the landlord/tenant rela-

tionship. A reputable firm will only pursue well-documented claims that are fully supported by the tenant and always treat the landlord with professionalism and respect regardless of the level of disagreement. The results of an audit must leave the tenant whole not only as it pertains to the lease expenses but his/her ongoing relationship with the landlord.

About the Authors



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