

LEASE COMPLIANCE AUDITS: A PRIMER

by Edward D Weberman*

Lease compliance audits ("LCA") have become increasingly common and necessary in an effort by commercial tenants to control occupancy costs. The purpose of LCAs is to determine whether the landlord has billed its tenant in accordance with the terms of the lease or other occupancy agreements. While an LCA is conducted long after the attorneys that were involved in the drafting of the lease believe that they have concluded their initial assignment, many of the issues that arise during an LCA could be avoided if the drafters were more familiar with the impact of the financial and operational provisions included in the lease. Unfortunately, many attorneys who negotiate lease documents are unfamiliar with the actual operation of commercial properties and the manner in which ongoing charges are billed to tenants by landlords.

In practice, the issues that are identified during an LCA include: (1) misinterpretation of the lease by lease administrators and others responsible for billing tenants; (2) failure to take into account negotiated exclusions or limitations; (3) incorrect inclusion of charges not related to the property in question; (4) inadvertent inclusion of charges that are not provided for in the lease; and (5) intentional inclusion of non-billable charges. While it is not possible for an attorney representing a tenant in the lease negotiation process to prevent intentional overcharges by the landlord, an understanding of how the financial and operational provisions of the lease will be interpreted following the execution of the lease is critical.

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Following the execution of a lease, in most situations the lease is handed over to the landlord's property management department and to the tenant's lease administration department. In both cases, the staff responsible for the ongoing enforcement of the lease are, in most cases, not attorneys and do not take the time or do not have the ability to properly interpret lease provisions. Typically, someone from both sides prepares a lease abstract, taking a lengthy document and summarizing it in two or three pages. In addition, many, if not most, landlords and tenants use lease administration software that does not allow specific exclusions or limitations to be properly taken into account. The simple solution to this problem is for both attorneys to arrange for the preparation of a sample billing incorporating the specific terms of the lease that they negotiated.

In addition to determining whether an LCA may be necessary, tenants should review all billings received from landlords. This process will allow the tenant to address some potential issues with the landlord without having to conduct an LCA. However, because most billings received from landlords may only include a summary of charges, by general account description (e.g., "Parking Lot Maintenance," "Landscaping," etc.), it may be impossible for the tenant to determine whether it has been charged properly. In addition, because tenants with multiple locations generally receive all of the reconciliations from their various landlords during the same time frame, a detailed review of all of the reconciliations so as to allow for timely payments

to the various landlords is not often possible. Further, many tenants are only able to compare a current bill to past billings and address only significant deviations. The problem with this approach is that the assumption has to be made that the prior billings were prepared correctly.

Of critical importance is attention to the definition of terms in the lease. Too often there is a lack of clarity, conflicts, or a simple failure to properly define terms. For example, in the case of a shopping center lease, a common provision may provide that the tenant is responsible for "its Proportionate Share of the Common Area Expenses, defined as the actual costs and expenses, determined in accordance with generally accepted accounting principles, on a cash basis, of maintaining, repairing, and insuring the Common Areas of the Shopping Center, including, but not limited to, ..., excluding". Exclusions often include capital expenditures, tenant specific related charges, leasing commissions, and depreciation of initial construction costs. While this type of clause may appear to be clear to the drafters, it often fails to properly take into account the specific nature of the development.

Common issues that arise include the following:

- (1) **Common Areas**—While the lease may specifically define Common Areas, many property managers and lease administrators assign a generic meaning to the term, often ignoring the definition of the term as provided in the lease.
- (2) **Shopping Center**—Leases typically include references to a site plan exhibit or define the Shopping Center to mean the shopping center commonly known as "XYZ Center." What are often not properly addressed are expansions, contractions, and situations where the Shopping Center is only a portion of a larger development. In addition, in situations where the Shopping Center is only a portion of a larger development, expenses relating to areas outside the Shopping Center are often miscoded by the landlord as Shopping Center expenses.
- (3) **Proportionate Share**—As basic as the concept of proportionate share may appear, many leases reference undefined terms such as floor area, mezzanine space, leasable space, leased space, adjoining property, outlots, and expansions. Even in cases where terms are defined in the lease, the tenant's proportionate share as reflected on the landlord's billing to the tenant often is not in accordance with the lease provisions.
- (4) **Generally Accepted Accounting Principles ("GAAP")**—Many attorneys incorrectly assume that the insertion of GAAP language in a common area maintenance ("CAM") clause sets a fixed standard that will take care of any billing issues. Because there are many GAAP standards, which in many cases are not consistent with the balance of the CAM clause, potential billing issues can best be avoided by clearly and specifically detailing what charges may be included in the billing to the tenant.
- (5) **Cost and Expense**—While the majority of CAM clauses reference the actual cost and expense incurred by the landlord, in many cases the landlord bills charges in excess of actual cost. Primary examples include the landlord's re-sale of electricity for common area lighting at a rate in excess of the landlord's actual cost, services provided by affiliates of the landlord, and the allocation of insurance premiums from a blanket policy covering multiple properties owned by the landlord.
- (6) **Capital Expenditures**—Many leases exclude "capital expenditures" from the charges allocable to the tenant, without providing a clear definition of what types of charges the parties intended to be considered capital expenditures for billing purposes. In many situations, the billings from the landlord include charges that under GAAP or federal income tax standards should be treated as capital expenditures. Nevertheless, disputes arise between the landlord and the tenant as to the proper classification of charges. In addition, disputes arise as to whether an expenditure is a normal recurring repair or a replacement. Most potential disputes could be avoided if the lease contained language that defined a capital expenditure as a repair or replacement that exceeded a stated dollar amount.
- (7) **Base Year**—Many office and shopping center leases provide that the tenant will only be responsible for its proportionate share of charges over either a stated amount or the charges incurred in a particular year. Problems arise when the tenant conducts an LCA years after the "Base Year" and the information supporting the Base Year expenses are not made available

to the tenant. For this reason, tenants should conduct an LCA for the Base Year and maintain that information with its permanent records.

- (8) **Cap on Increases**—Many leases contain provisions that, for billing purposes, certain expenses cannot increase from one year to the next in excess of a fixed percentage or by the increase in a defined consumer price index. Because this type of provision may only apply to a specific tenant, billings to the tenant that has this type of protection may not properly reflect the negotiated limits.
- (9) **Insurance**—Billings to tenants often include charges for insurance premiums for coverages that are not reimbursable under the lease. In many situations a lease will provide that the tenant pays its proportionate share of general liability insurance premiums relating to the common areas and property insurance premiums relating to the buildings. However, the insurance premiums included in the billing to the tenant may include premiums related to additional insurance coverages. In addition, in situations where the property in question is insured under a blanket policy that includes multiple other properties owned or managed by the landlord or its affiliates, allocation issues and the determination of the portion of the premiums that are properly allocable to the property in question becomes problematic. Further issues arise when the landlord maintains a self-insured retention program. From an audit prospective, tenants should request copies of the actual insurance policies, including premium endorsement schedules.
- (10) **Common Area Electricity**—In a large number of situations, especially in cases where the landlord re-sells electricity to the various tenants and to the common areas, the landlord does not have a separate meter to measure the common area electricity consumption. In those situations, the common area electricity charges that are reflected on the billings to the tenant are either estimated or computed on a left-over method. As a result, the charges are often significantly overstated. A useful audit function is to perform a load study of common area consumption based on the number and types of fixtures, hours of operation, and the cost of the electricity.
- (11) **Building, Roof and Structural Expenditures**—In situations where the landlord is responsible,

at its sole cost and expense, for building, roof and structure expenditures, an LCA will identify charges that should not have been included in the billings to the tenant. When the billings received from the landlord do not specifically reflect these types of charges in separate categories, a review of the supporting detail is necessary.

- (12) **Management Fees**—Many leases provide that CAM charges relate to the costs and expenses of maintaining only the common areas, with additional language that provides for expenses to include management fees. Because management fees are often paid to the landlord or the landlord's affiliate, relate to services provided for non-common area functions, and are determined based on a percentage of rents, significant issues may occur.
- (13) **Real Estate Taxes and Special Assessments**—While typically contained in a separate section of a lease, allocations and the tenant's obligation to participate in special assessments often are issues that need to be addressed.

When should an LCA be performed? As discussed above, if not prohibited under the lease, it makes long term financial sense to conduct an initial LCA following the first year of a lease. That way, it should be easier to resolve any differences between the landlord and tenant because issues will not have accumulated over a number of years. Thereafter, a program to have LCAs performed on a periodic basis should be established.

Particular attention must be given to what has become to be known as an "audit clause" contained in many leases. These clauses, which should be specifically addressed during the lease negotiation process, often place time limits on the tenant's right to have an LCA conducted and deal with the tenant's right to seek reimbursement for the costs incurred to have the LCA performed. In addition, many leases contain very burdensome language as to who can perform an LCA and how the auditor can be compensated. Tenants often prefer to engage an auditor on a contingent fee basis, so as to limit its out-of-pocket exposure. Many landlords resist contingent fee compensated auditors under the premise that because the auditor has a financial interest in the resolution of the matter that the auditor will not make reasoned and supported positions. In practice, however, while a firm conducting an LCA should be an advocate for its client, the auditor has no ability to identify non-existent issues.

Following the engagement of the lease compliance auditor, the auditor should receive and detail review the lease and other occupancy related agreements, billings, and supporting documentation received by the tenant from the landlord, and conduct an on-site visit of the property, if necessary. In many situations, what is known as a "desk-top audit" can be performed, if the landlord is willing to provide the required supporting documentation electronically or by other means. At the completion of the auditor's review of available information, the auditor should contact the landlord and provide the landlord with a detailed list of information that the auditor requests to review. Cooperation between the landlord and tenant during the audit process is beneficial to both parties. Because the parties in most cases will have a continuing business relationship, the process need not be adversarial.

The audit process includes securing and performing a detailed review of all available supporting documentation, including copies of the landlord's detailed general ledger, paid invoices, service agreements, insurance policies, and other documentation that is relevant under the circumstances. Throughout the process, it is most efficient for the auditor to maintain contact with the landlord so that on-going questions can be answered and additional documentation can be received to clarify open points.

Following the completion of the review of all available information, a detailed report of findings should

be delivered to the tenant for its review and approval, prior to delivering the report to the landlord. After the tenant has reviewed and approved the proposed report, the report should be transmitted to the landlord for its response.

The audit resolution process can become tense as both sides work through the issues. Landlords, understandably, often resist the process and tenants want to resolve issues relating to prior billings and ensure that future billings will be in accordance with the terms of the lease. Nevertheless, the vast majority of LCAs are resolved between the parties without the parties having to litigate the issues or involve themselves in other forms of alternative dispute resolution.

Most large national tenants have established LCA programs, with many maintaining internal staff to perform LCAs in conjunction with third party LCA firms. In addition, many national landlords have established lease dispute departments to address billing and audit issues. Working together with a joint familiarity of the process, these tenants and landlords have been able to develop audit resolution programs. In addition, many regional and local tenants have had LCAs performed, with many realizing significant reductions in operating costs. During these turbulent economic times, it is more important than ever to contain costs that were long considered to be uncontrollable.