

Real Estate Strategies

What You Don't Know—About Your Lease—Can Hurt You!

BY PAUL STEVENS

BUSINESSES LARGE AND SMALL ARE IN A SQUEEZE PLAY. IT'S NO SECRET WHY—INFLATION AND ECONOMIC UNCERTAINTY COMBINED WITH THE INABILITY TO FULLY PASS ALONG INCREASED COSTS TO CUSTOMERS.

With bottom lines under such universal attack, a growing number of corporations are revisiting lease audits as a tool to cut costs, since rent is the second largest operating expense for a business after employee compensation.

Landlords, by contrast, seem to have little problem passing along their rising costs to tenants. Sometimes, however, they may abuse the privilege.

Here are some examples reported in *The New York Times* of how successful, professional lease audits helped smaller businesses recoup wasted money:

- A publishing company discovered it was charged \$100,000 for an installation of a new cooling tower, a capital item that can't be expensed to a tenant, and an extra \$28,000 per year in cleaning costs based on an underreported base-year cost. The company received credit against its rent.
- A textile company subletting 12,000 square feet found that the primary tenant was allocating disproportionate share of its own escalations to their company, which recouped \$175,000.

Not all situations have an immediate, satisfactory resolution. An outside audit revealed that Cincinnati-based bank, Fifth Third Bancorp, was overcharged more than \$800,000 in operating and maintenance expenses by Danis Properties, Inc. The landlord disputed this finding and filed a lawsuit in May 2007.



The bank's experience is a reminder that commercial tenants must pay greater attention to the impact of lease clauses on their rent bills, particularly during the initial or base year. Most companies can't afford the time and energy to scour their rent bills for overcharges because it is hard enough to run their own business. A lease is a complicated document that requires the erudition of industry experts, such as a professional lease auditor who can catch seemingly minute mistakes that multiply over the years into major losses. Here are some typical areas of dispute:

- Inclusion of certain expense and tax pass-throughs—increased building operating costs are shifted or “passed through” to the tenant. However, most leases do not allow the pass-through of tenant-procurement costs, financing and ownership costs, building depreciation, or capital improvements.

- Establishment of an underreported base year—the rent stated on the lease supposedly reflects the full costs of operating and managing the building at the beginning of the lease year, or the “base year.” In case of inflation, the lease will also include an operating expense escalation clause, which dictates that the tenant will pay the levels of cost increased over the base year amount. However, the rent for the base year might have been underreported due to existing warranties and building vacancies. Landlords might also low-ball the base year to attract tenants.

Other common areas of dispute can include space issues and miscalculation of electricity fees. The landlord might discreetly make a profit at your expense by purchasing electricity in bulk and reselling it a market price.

Having a professional, exclusive tenant broker negotiate the lease can help head off many of these problems.

Now that we’ve discussed the areas covered by lease audits, when is the best time to have one? Here are four “occasions”:

- A base year audit is the most important audit. For a net lease, the base year audit would be done for the first lease year, since the tenant is responsible for paying its pro-rata share of all expensed starting on day one of the lease. This audit establishes the proper expense level against which all future year’s expenses will be measured, while documenting the landlord’s methodologies for calculating the base-year expenses. This compels the landlord to determine expenses on

an “apples to apples” basis. For a gross-lease, the audit should be performed the first year that the tenant is responsible for operating expenses or tax escalations.

- If building ownership changes hands, consider an audit. New owners look to improve their margins—often at the expense of the tenants.
- In the final year or two of its lease, an audit may provide not only financial reimbursement, but leverage for negotiating a lease extension.
- If the expenses rise beyond what appears reasonable, an audit may be appropriate. Review the year-to-year increases in specific expenses before doing an audit. If expenses rise sharply year-to-year due mostly to increased utility costs, an audit is probably not necessary.

Which tenants would benefit from performing a lease audit?

The larger the space, the greater the potential for overbilling. A tenant should have at least 20,000 square feet before considering an audit since there are normally minimum audit fees, although in some instances a base year audit might be economical.

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