Which Office Tenants should consider a Lease Audit?

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Should all Office Tenants audit their Landlords' operating expenses annually? The answer is probably no. However, there are certain situations when auditing the Landlord's lease operating expenses may be a very prudent business decision, especially in today's turbulent economy.

For most Office Tenants, rent is their second largest operating expense, exceeded only by personnel costs. An Office Tenant's lease should provide audit rights to inspect the Landlord's financial documentation for annual operating expense and real estate tax increases, often called "escalations", that are related to a commercial lease. Auditing the Landlord's operating expenses is the only way for a Tenant to assure that a Landlord is billing the Tenant fairly and properly.

Base Year Audit – A Base Year audit is the single most important audit that any Office Tenant can have performed. This audit provides two (2) valuable benefits to an Office Tenant. First, it properly establishes the Base Year expenses, because all future annual expenses will be compared to the Base Year figures to determine an Office Tenant's yearly liability of its share of the Landlord's annual operating expenses. Second, it sets the stage by providing proof of how Base Year expenses were actually calculated by the Landlord (or the Landlord's property manager). In the event of a future sale of the building, this is critically important, as a new Landlord often calculates expenses quite differently than the previous owner, potentially causing a Tenant to incur greater expenses than actually allowed by its lease.

While Base Year audits are extremely valuable to all Office Tenants, Base Year audits for Tenants with leases in new or redeveloped buildings can yield even significantly more value for two (2) reasons. Number one, these types of buildings often have high vacancy levels and Landlords tend to understate Base Year expenses, due to the improper "gross-up" of expenses (see High Vacancy below about the "gross-up" concept). Number two, new or redeveloped buildings will often have construction warranties in place. As a result, these particular Landlords do **not** incur normal maintenance costs for building systems during the Base Year, mainly because elevators, heating/cooling systems and other systems are still within their warranty periods. In both instances, Landlords may understate the Base Year operating expenses. This in turn triggers an overpayment of operating expense escalations by Office Tenants for all lease years subsequent to the Base Year. Essentially, an Office Tenant's unpleasant surprise can wait quietly in the wings and not become apparent until later in its lease term.

Large Leases – Numerous factors determine the optimal size for a lease that might be audited. Typically, any "gross" lease in excess of 25,000 square feet or any "net" or "triple net" ("NNN") lease greater than 10,000 square feet should be reviewed annually to determine if a detailed audit is advisable. Why would a "gross" lease of 25,000 square feet and a NNN lease of 10,000 square feet be equal audit candidates? This is because a "gross" lease has a Base Year amount equal to the actual expenses for a given period of time, such as calendar year 2009, whereas a NNN lease has, in effect, a Base Year amount of zero dollars ($0.00). Consequently, if a Tenant has a gross lease and a Landlord consistently includes a particular expense item in the Tenant's operating expenses that should **not** be included, then the Tenant has only been harmed by its pro-rata share of the increase in this expense as compared against the Tenant's Base Year amount. However, a Tenant with a NNN lease is harmed by its pro-rata share of the entire expense amount, since there was no Base Year amount. Even a relatively small error can lead to substantial savings for Office Tenants of these sizes.

Mixed-Use Properties – Landlords of mixed-use properties, which include elements such as office space, retail space, residential, parking garages, theatres, supermarkets, etc., routinely overcharge Office Tenants

for operating expenses and real estate taxes. This occurs because the Landlord is allocating expenses to the various elements of the complex using methods that don't reflect the actual usage of services by each element. In more extreme cases, Landlords will actually be reimbursed **more** than they actually spent for such services. In cases like this, the expression "the sum of the parts is greater than the whole" can turn out to be a reality.

Sale of Building or New Landlord – Prior to the sale of an office building, a seller (Landlord) may spend substantial sums of money for deferred maintenance in an effort to reduce any price concessions that a potential buyer might seek. Often these expenditures are capital in nature and, although often not permitted by a Tenant's lease, the Landlord will still attempt to pass these one-time costs through to its Tenants as operating expenses. Also, a new Landlord will tend to have new ideas about how to run its new building. It's fairly common for a new Landlord to use more aggressive methods to determine the operating expenses, because a new Landlord realizes that it can enhance the yield on its new investment by piling more items and higher costs into its operating expenses.

Large Increase in Operating Expenses – Substantial operating expense increases often signal that a Landlord has improperly calculated its expenses. A Tenant should look carefully at a Landlord's individual expense line items, not just the grand total, when reviewing year-to-year increases. For example, if electric expense grew by 20% and cleaning expense increased by 9%, the Tenant should actually be more wary of the 9% growth in cleaning expense, because this line item typically tracks with the growth of Consumer Price Index ("CPI") its market area.

Major Capital Expenditures/Repairs – Office buildings in which Landlords have spent major capital on building systems, exteriors or common areas certainly should be considered as an audit target. While a Landlord may attempt to pass-through these costs to its Office Tenants, each individual lease dictates if such capital expenditures are permissible or not. Typical office leases only permit Landlords to amortize capital expenditures, which (a) are required by a new law that comes into effect subsequent to the commencement date of a lease, or (b) result in an actual reduction of the building's operating expenses.

Final Lease Year – An audit performed within the final two (2) years of a lease expiration date may provide several benefits. First, overcharges by the Landlord may be identifiable later and then reimbursed to the Tenant. Second, by uncovering any overcharges, a Tenant will be better prepared to negotiate its next lease, either at the same building or elsewhere, to include protective language related to a Landlord's potential overcharges and/or tougher lease audit rights for the Tenant.

High Vacancy Levels – The "gross-up" of operating expenses is addressed in most leases and, if applied properly, is fair to both the Tenant and the Landlord. Typically, if an office building has an average occupancy of less than 95%, a Landlord is entitled to adjust certain expenses that vary with actual levels of occupancy and then reflect them as if the building were 95% occupied. For example, this would include the janitorial/cleaning contract, cleaning supplies, trash removal, water and sewer and property management fees. If applied correctly, the gross-up provision will provide protection to both the Landlord and the Tenants. However, when a building has a high vacancy, then a Landlord can make significant errors when applying this gross-up adjustment, which will negatively impact an Office Tenant's share of the annual operating expenses, resulting in the Tenant paying too much.

Tenant-vacated Premises – It is not uncommon for large Office Tenants to negotiate new leases in multiple locations and buildings. Consequently, Office Tenants will legitimately continue to pay rent and expense escalations in locations that they have vacated and no longer occupy. Unfortunately, Landlords frequently continue to charge their departed Tenants for services that Tenants no longer require, such as janitorial/cleaning services, cleaning supplies, water & sewer and trash removal. While most office leases do not permit the Landlord to continue charging the departed Tenant for such services, Landlords seldom abide by the lease in this department. So the unaware Tenant, who is diligently paying rent for its vacated premises, gets overcharged by the Landlord, who pockets the unintended "gift" from the Tenant.

Conclusion – An Office Tenant should conduct its own due diligence regarding the Landlord's operating expenses related to a lease, both prior to and during the lease term. Limitations in time, personnel and fiscal resources are common reasons that Office Tenants often give for not diligently pursuing their audit rights under an office lease. However, it is very important that an Office Tenant hold its Landlord accountable, making sure that specific terms of the lease, as well as the spirit of the lease, are being followed properly and fairly by the Landlord.

A preliminary review of an Office Tenant's lease and operating expenses helps to reveal whether or not an audit is even advisable. If a Tenant undertakes a lease audit, it may be possible to save substantial sums of money over the term an office lease. And every dollar saved as a result of a successful lease audit can be a valuable dollar of net profit.

If you have any questions about an office lease and
whether or not a lease audit might be advisable for your organization, please contact:

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