

Negotiating Audit Rights in Leases

After years of refunding rent overcharges to tenants, landlords across the country are striking back: they are creating obstacles to stop tenants from auditing and challenging their lease charges.

What are Lease Audit Rights and Why Does a Tenant Need Them?

In most leases, the tenant is obligated to pay for a share of building operating expenses, taxes, utilities and other costs. The provisions that impose these obligations are often complex, requiring a high level of diligence on both the landlord to bill correctly and the tenant to monitor the charges.

Errors are commonplace. Statistics show that close to 90% of leases have mistakes, mostly because landlords' administrative personnel don't tailor the bills to each individually negotiated lease.

Often, the only way for a tenant to know if the bills are correct is to dig into the landlord's accounting records related to the property.

But do tenants have the right to do this?

Audit Rights Specifically Granted by the Lease. Many leases grant tenants the right to review the books and records of the landlord to ensure that the charges billed are correct. Similar rights exist in partnership agreements and many other types of financial contracts.

Audit rights can be found within the clauses outlining the tenant's obligations to pay these charges. These clauses often state that the tenant has, upon reasonable notice, the right to visit the landlord's offices and review the applicable accounting records. These clauses sometimes also have procedures for resolving any disagreements that may result.

Audit Rights Granted by the Law. Every tenant has a general contract right to ensure that the bills received are correct. This right comes from any contracting party's general right to enforce its agreement.

Other rights exist as well. Some courts have specifically read into the lease an implied right for the tenant to verify the numbers, and others have gone so far as to make an audit a precondition to the tenant's obligation to pay the invoice.

In addition, any party to a contract can bring a suit for an "accounting," which would require the other party to substantiate and verify the charges flowing through the agreement. Of course, if the tenant suspects an overbilling, it can always sue for breach of the agreement.

It is not suggested that any of these remedies be pursued by tenants on a regular basis. But it is important for the tenant to know its rights so that it can effectively negotiate the

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Keeping Tenants from Checking Their Bills. During lease negotiations, landlords regularly try to convince tenants to willingly accept limitations in these rights. Two common ways are as follows:

Shortened Time Limits

Many landlords ask the tenant to provide a detailed written objection to the landlord's bills within a very short time period--in most cases 30-90 days--failing which the bill is "conclusive and binding" on the tenant, who is "deemed" to have agreed to the bill as rendered.

The landlord's most common argument for this limitation is that it needs to "close the books" for the year in question. Of course, the flaw in this argument is that the books for the year being billed have already been closed (they were closed prior to rendering the statement).

The problem with accepting this limitation is that it is virtually impossible for most tenants to determine whether there is anything wrong with the bill within 90 or even 180 days. That's because making such a determination often requires lots of steps: hiring a lease audit firm to review the lease and the bills; gathering needed internal information; coordinating schedules for an audit; conducting an on-site review of the building's books and records; completing the analysis; preparing a report; presenting the findings to the landlord. Each step can take weeks or months.

Any restriction that effectively prevents the review from taking place should be removed from the lease.

The result? The work can't be done within the time limit and the tenant can't meet the deadline. Any overcharges that may exist are lost forever.

What's most ironic about these clauses is that without a time limitation in the lease, the tenant's right to audit is governed by the statute of limitations. This is the time a party to a contract has to enforce its rights. In most states, should a landlord bill a tenant incorrectly (i.e., breach its lease agreement), the tenant would have 4 to 10 years in which to bring an action against the landlord.

Thus, when a tenant agrees to limit the time to a number of days, it is severely reducing the rights it otherwise would have under the law. At a bare minimum, the tenant should have a year or two to review the charges.

Restrictions on Who Can Do the Audit

Another common restriction is to require the tenant to use a "Big-5" accounting firm, or a firm that is not compensated on a contingency fee basis.

The landlord's argument here is that contingency firms are more "aggressive" in pursuing overcharges than non-contingency or accounting firms and will pursue items that are not legitimate. However, let's examine the facts:

- Contingency audit firms are very careful not to pursue claims that aren't legitimate because they ultimately won't get paid for their time.
- Most audit firms are controlled directly by their clients and by contract can't exceed their mandates.
- If contingency lease audit firms have a bias, it is the same as that of the tenant: to eliminate charges that are inconsistent with the lease. The compensation structure simply ensures that this goal is always in view.

The important point here is that a landlord has no legitimate interest in telling a tenant who can work on its behalf. Would it ever tell a tenant not to use a certain attorney or broker? Would the tenant ever think it appropriate to tell the landlord which HVAC contractor to use or how to compensate it?

Contingency audit firms exist because tenants don't have the time to focus on these issues and can't budget the expense needed to audit leases on an hourly or fixed-fee basis.

Thus, the result of this restriction is that although the tenant has permission to verify the charges, in reality it most likely won't be able to do so.

Conclusion

Many hours are expended negotiating and drafting operating expense, tax, utility and other similar clauses. Yet, despite all of the "points" that a tenant may win in this negotiation, it frequently gives it all up by agreeing to restrictions on its ability to enforce these provisions.

As long as there are leases that have complex financial terms, there will be a need for tenants to check the landlords to ensure compliance. Any restriction that effectively prevents the review from taking place should be removed from the lease.

Source: www.kbalease.com