

Sorting out the jargon

Good lease management can be a complex area for tenants, but thanks to audit professionals it can be easily sorted out

Most North American commercial leases for office space, retail businesses or industrial premises contain additional rent clauses requiring tenants to pay a share of the operating expenses and property taxes of the buildings where their offices are located. Sometimes several pages long, these clauses are usually drafted in legal jargon and are generally extremely complex, both to understand and to administer.

The audit of additional charges in commercial leases, commonly called a lease audit, consists of performing a detailed review of a tenant's occupancy costs to ensure consistency with the lease provisions. The purpose of this process is to ensure that rent billing is accurate and compliant with the provisions of the lease in order to identify and recover amounts a landlord may have overcharged the tenant.

Year after year, many tenants of commercial spaces pay more rent than they should. In some cases, the amounts are substantial (see table below).

Why does this happen?

Good lease management by tenants means more than paying rent on time, paying the annual adjustment for additional rent billed by the landlord and exercising your rights and fulfilling your obligations within the deadlines specified in the lease. Lease clauses setting out additional rent, or pass throughs such as a share of heating and maintenance costs, are varied and complex. In many cases, tenants lack the expertise to understand lease clauses, measure their scope and verify how they are being applied by landlords. As a result, tenants are often at a disadvantage.

Landlords, on the other hand, know their buildings inside out. They have a sound grasp of the real estate market and the administration of additional rent inherent in a lease. Even though additional rent clauses are drafted with the utmost care, the nature of these provisions can lead to different interpretations, depending on each party's understanding. Since these clauses are always administered by the landlords, they are often interpreted at the tenant's expense.

Some landlords tend to use aggressive accounting poli-

Reviewing the rent

Building location	Type of building	Square footage	No. of months audited	Amount claimed as overpayment	Claim per sq.ft./year
Brampton, Ont.	Commercial power centre	121,779	60	\$249,253	\$0.41
East-central Montreal	Office	186,000	36	\$128,949	\$0.23
Mississauga, Ont.	Commercial power centre	157,200	24	\$ 94,852	\$0.30
Old Montreal	Office	20,500	22	\$ 81,888	\$2.18
Old Montreal	Office	18,878	36	\$ 77,968	\$1.38
Old Montreal	Office	17,500	72	\$ 58,177	\$0.55
Downtown Vancouver	Office	52,543	9	\$ 58,075	\$1.47
Old Montreal	Office	9,510	48	\$ 48,407	\$1.27
Vancouver	Office	57,026	12	\$ 37,359	\$0.66

cies in order to collect the tenant's share of recoverable operating expenses without delay. In addition, since their accounting staff doesn't always have the time to fully understand every lease under management, they tend to simply bill tenants for additional charges according to standard leases proposed by the landlord, even if in reality leases often include specific clauses arising from negotiations between the parties.

Lastly, since only a minority of tenants actually opts for lease audits, landlords will often interpret and administer the additional rent clauses to their advantage, with no fear of being challenged by their tenants.

The most common mistakes

Below are some examples of pass-through billing errors that may be detected during a lease audit:

- disbursements included outright in operating expenses when they should have been capitalized and amortized over their useful life;
- certain charges included in operating expenses when they were specifically excluded under the lease;
- landlord's general administrative and operating expenses included in the building's operating expenses, when administrative fees are already included and payable to cover these general expenses (cost duplication);
- tenant's proportionate share calculated improperly;
- building's operating expenses include costs that should have been billed directly to one or more tenants;
- amortization periods that are too short for capital projects given their useful life;
- common-area expenses allocated improperly between the various components of building complexes;
- accounting entries for year-end accrued expenses in excess of actual costs;
- cut-off errors; and
- gross-up calculation errors for certain expenses that vary based on building occupancy rates.

Advantages of a lease audit

A lease audit enables tenants to benefit immediately from often substantial savings on rent-related pass-through charges.

What's more, the errors identified during a lease audit will often have an impact over several years, which will in turn mean lower occupancy costs for tenants later on. Furthermore, since landlords will expect their leases to be audited again by the same tenants, they tend to manage them less aggressively. If the audit is performed at a strategic moment during the term of the lease, it could also serve as significant leverage for the tenant when negotiating benefits or concessions the landlord may previously have been unwilling to grant. In other words, a lease audit will level the playing field between the parties and compel the landlord to show more respect for the tenant's control environment and governance practices.

Exercising the right to conduct a lease audit

As with most cases of personal remedy, exercising the right to conduct a lease audit is normally subject to a limitation period,

which varies from province to province. Generally, this period begins on the date the tenant receives the building's annual financial statements from the landlord.

• Ideally, the lease should include clear and specific clauses respecting the tenant's right to conduct a lease audit and how to exercise that right. Even if some leases contain no such clause to that effect, some landlords will in good faith open their books to their tenants. Should this not be the case, tenants in Quebec could try to force their landlord to do so based on certain clauses set out in the Civil Code of Quebec. Under the code, contracting parties are required to act in good faith and with loyalty, to cooperate and inform, and to refrain from infringing upon each other's rights.

• Tenants in other provinces can also try to force their landlords to open their books under common law — case law exists to this effect.

Using the services of a professional

Few enterprises have had their leases audited. First of all, most of them simply don't realize that this service exists. Others are unaware of their rights in this regard or that they are entitled to examine the pass-through charges billed by their landlords. Some tenants worry about poisoning their business relationship with their landlords, even though these landlords may charge them more rent than what was agreed upon when they signed the lease.

Lease audit professionals have real estate expertise and the necessary resources and can help tenants secure their right to conduct a lease audit if their leases are not clearly worded. They can help maintain a good business relationship with the landlord by acting as an intermediary between the tenant and landlord. They also will be able to obtain greater refunds from the landlords than the tenants could themselves. In addition, they can negotiate with landlords and determine how credible their arguments are. Professionals know the ins and outs of the real estate market and commercial leases and can train tenants' lease administrators so they can more effectively manage their leases in the future.

Note that some professionals do not invoice for their services but are compensated on a basis contingent upon a percentage of the amounts refunded by the landlords.

A competent lease auditor must have an in-depth knowledge of the following:

- commercial real estate;
- lease management;
- financial and legal interpretations of the various lease clauses;
- accounting and accounting standards;
- external auditing;
- management and administration methods used by landlords; and
- negotiations.

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