



Protecting Commercial Tenants Against Unfair Billings

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Quite often, commercial property tenants receive annual bills - commonly referred to as an “Annual Statement” or “Annual Reconciliation” - from their landlords for charges that are in addition to base rental amounts. For this article they will be referred to as “Statements”. Under a typical commercial lease, the landlord usually seeks to recover from its tenants the costs of operating the building and property in which the leased premises is located, commonly known as the “Operating Expenses”, as well as the Real Estate Taxes that the landlord pays for such property.

In order to seek reimbursement for Operating Expenses and Real Estate Taxes from the tenant, the lease must have provisions which give the landlord the right to collect these reimbursements as additional rent. A typical lease may even provide that an annual budget is prepared by the landlord, and is provided to the tenant in advance, which sets forth an estimation of the monthly charges that the tenant may be billed as additional rent towards Operating Expenses and Real Estate Taxes. Alternatively, the lease may state that the tenant shall pay the additional rent to the landlord within a certain number of days that the landlord presents the Statement to the tenant.

The lease typically may provide that after the landlord closes its books for the year, the Statement of the Operating Expenses and the Real Estate Taxes amounts will be provided. In such an event, the tenant will pay any increases in the additional rent above the estimated charges or may receive a rental credit should the actual expenses be less than those that were budgeted and previously paid by the tenant.

The tenant should only be obligated to pay Operating Expenses and Real Estate Taxes based on its leased percentage of the property (i.e., its pro-rata share). For example, if the property is 100,000 square feet and the tenant’s leased premises is 25,000 square feet¹, the tenant should reimburse the landlord for 25% of the Operating Expenses and Real Estate Taxes expenses. The tenant’s advisors should be careful during the lease negotiation period to confirm that the property square footage numbers and the leased premises square footage numbers are accurate for purpose of calculating their client’s pro-rata share, as a mistake here can have a negative financial impact to the tenant throughout the entire lease term.

Other items that should be clearly defined and understood include:

- ⇒ Allowable expenses
- ⇒ Escalatable expenses vs. Fixed expenses
- ⇒ Repairs & Maintenance—what can be expensed and what should be capitalized?
- ⇒ Understanding the landlord’s capitalization process and term
- ⇒ Understanding what insurance the tenant is directly and indirectly responsible for
- ⇒ Tenant Improvement Allowances—when to negotiate an amount and how that amount can be applied?
- ⇒ Understanding Property History— who are the other tenants, and what type of businesses lease in this building?

¹ For purposes of this discussion, we will not differential between usable square footage and rentable square footage. *Continued...*



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The lease should set forth, in detail, those expenses that are considered legitimate Operating Expenses. Such expenses typically include those expenses incurred by the landlord in operating, maintaining and/or repairing the property. These may include utility costs relative to common areas, janitorial services, snow removal, maintenance of parking lots, landscaping, replacement of worn or damaged equipment, insurance costs, salaries/wages/benefits of persons engaged by the landlord in the operation, maintenance and repair of the property, management fees of the property manager, and generally other costs or expenses which, in accordance with generally accepted accounting principles and the standard management practices for commercial buildings comparable to the landlord's property, would be considered as an expense of operating, maintaining and/or repairing the building.

Excluded from Operating Expenses are typically capital improvement costs associated with the property, costs reimbursable to the landlord by insurance, cost of work performed specifically for a tenant for which the tenant reimburses the landlord, tenant fit-up costs in preparing new space for a new or renewing tenant, real estate broker fees or commissions, any costs for any lease concessions or inducements for tenants, debt service costs, advertising/marketing, costs unrelated to the property/building, and any fines or penalties incurred by the landlord due to violation of any building codes.

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- ⇒ the tenant's right to choose whether or not to use an outside third-party,
- ⇒ what type of firm that can be used,
- ⇒ and, most importantly, the fee arrangement that can be used (i.e., Fee vs. Benefit Share)

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A good advisor will ensure that the tenant's lease includes a strong audit clause aimed at ensuring the tenant's rights to investigate and ensure it is paying its appropriate share of allowable Operating Expense or Real Estate Taxes, as well as its appropriate rent in line with the lease. The tenant should have the right to audit and inspect all the landlord's books and records pertaining to any Operating Expenses and Real Estate Taxes for which the landlord is seeking reimbursement. This right to audit should be for as great a period as can be negotiated in the lease but typically no less than a two-year period. In the audit, the tenant or the tenant's representative, at their request, should be permitted access to the landlord's books and records (not limited to detailed general ledger), invoices, contracts, specifications, quotes, receipts, cancelled checks and any other materials that evidence or support any charges the landlord is attempting to receive reimbursement for as additional rent.

Another important point to have included in the audit clause is the tenant's right to choose whether or not to use an outside third-party, what type of firm that can be used, and most importantly, the fee arrangement that can be used (i.e., Fee vs. Benefit Share). Over the years, many landlords have resorted to including very stringent and directed audit clauses that in many times handcuff the tenant from performing such audits.

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Generally the tenant's counsel will have addressed the audit right provisions and lease compliance issues in the negotiation and preparation of the lease so as to best protect the tenant's interests. However, years after the lease is completed and the tenant starts receiving the landlord's Statements, how are the tenant's interests best protected visa-vi the accuracy of those Statements or even visa-vi non-base rent payments that the tenant is regularly paying?

The tenant may simply either rely on the Statements in the hope that they are accurate, or the tenant may opt to undertake an audit of the Statement (or compliance assessment of other non-base rent payments being made to the landlord). Although this audit can be either internal by the tenant or with the assistance of a third-party auditor, we strongly recommend that, unless the tenant has a lot of free time, has significant accounting and real estate experience, and has regularly performed lease audits in the past, the tenant should retain a third-party professional in undertaking such audits or lease compliance reviews. The benefits of using such third-party professional compliance and audit specialist include, but are not limited to:

- ⇒ Detailed analysis of the statement and supporting documentation.
- ⇒ Historic financial modeling and trend analysis for comparison purposes.
- ⇒ Local and regional data for comparison purposes.
- ⇒ Years of experience and comfort with sophisticated lease language and numerous types of calculation methods.
- ⇒ Knowledge of what fair administrative and management fees are being charged by other landlords in the region.
- ⇒ Insurance considerations: claim costs vs. actual reimbursements where tenants may possibly have been due a credit.
- ⇒ Capital improvements vs. Repairs & Maintenance analysis.

In addition to the engagement of competent counsel in negotiating the lease, the prudent tenant may also wish to engage such a third-party audit and compliance specialist during the lease negotiation stage to assist in ensuring that the best financial elements exist within the tenant's lease. This can result in significant future savings for the tenant.

About the Authors



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