

Navigating Through Audits

With effort from both landlord and tenant, the rough waters surrounding audits can be calmed.

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The right to audit stirs up a sea of controversy between landlords and tenants — as much or more than any of the findings that the audit might uncover. Whether the dispute concerns the right to audit in the first place or how the audit is conducted, this is an increasingly sore subject for both landlords and tenants.

Generally, two types of audits are at issue: landlord's audit of tenant's gross sales; and tenant's audit of landlord's operating costs, which includes CAM, real estate taxes, insurance and utilities. However, the fact that each side claims some rights to audit by no means guarantees that each side ends up with the same rights.

Auditing the tenant

Few would doubt the landlord's right to audit tenant's gross sales to ensure the accuracy of the tenant's percentage rent. Audits of this sort are rarely a source of controversy, even though a large chain retailer may have to host dozens of these audits each year.

A typical mall or strip center lease permits the landlord or its authorized agent to audit the tenant's books at least once each year and requires the tenant to reimburse the landlord for audit expenses (including travel) if the tenant has understated its gross sales by 1 percent or 2 percent. The lease may also require the tenant to maintain its gross sales records for at least three years, and may stipulate that failure of the landlord to audit the tenant's books does not constitute a waiver by the landlord of its right to audit.

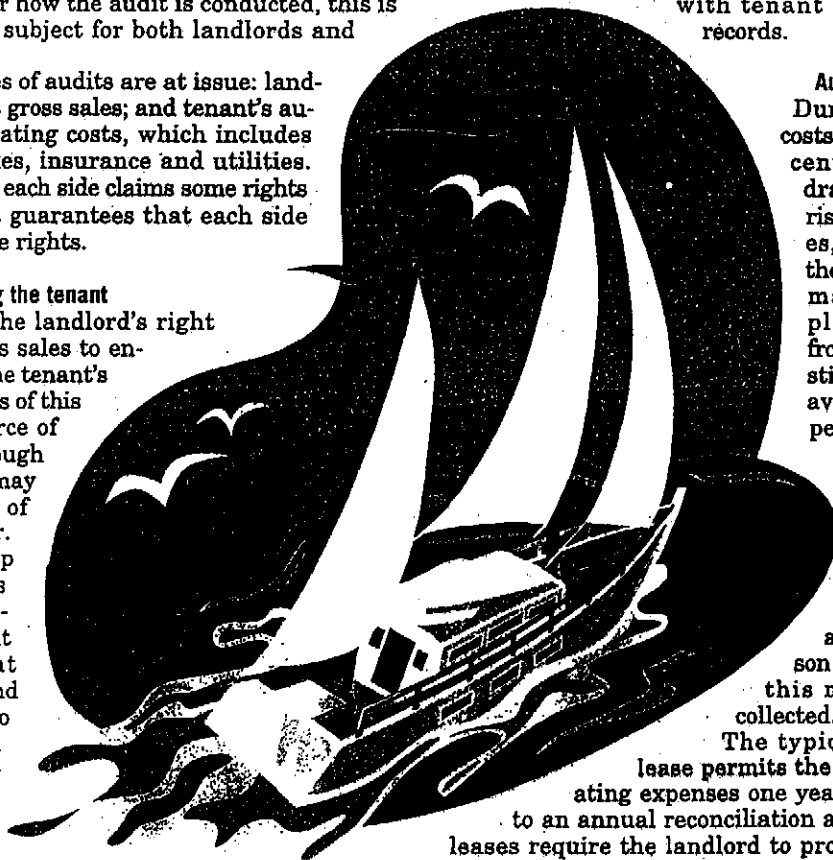
While there are always some issues left to be negotiated — for example, how to determine landlord's reasonable audit expense — few tenants dispute these landlord audit rights. Such is not the case, however, with tenant audits of landlord's records.

Auditing the landlord

During the past decade, costs of operating shopping centers have increased dramatically because of rising local property taxes, labor costs, and, as the centers age, costs of maintenance and replacement. Statistics from the Urban Land Institute indicate that the average tenant in a superregional center pays about \$10 per sq. ft. for operating expenses, a sum frequently greater than 50 percent of its total rent. Obviously, both landlords and tenants have reason for concern about how this money is spent and collected.

The typical shopping center lease permits the landlord to bill operating expenses one year in advance, subject to an annual reconciliation and adjustment. Most leases require the landlord to provide "reasonable detail" of operating-cost charges in the annual reconciliation. Even if the lease does not explicitly require "reasonable detail," several court decisions have held that it is implied in the lease.

The degree to which a tenant may then audit these reconciliations runs the gamut from no rights at all to full rights through the life of the lease. Some leases flatly



prohibit any right to audit or, trying to accomplish the same end, make the reconciliation "conclusive" once sent to the tenant or once "certified" by an accountant (whose fees are charged to the tenants).

On the other end of the spectrum are leases that provide an unrestricted right to audit, with no limitations on scope, confidentiality or number of years that may be audited.

As is usually the case with extremes, both of these present problems.

Prohibiting audits altogether may sound appealing to landlords, but the landlord that refuses outright to permit audits may be outsmarting itself. Many of its penny-wise tenants may feel that operating charges without audits are an unnecessary risk — i.e., a "blank check" — and find better deals elsewhere. Other tenants may want to cut back on rent for fear that operating-cost charges will soon escalate.

Moreover, landlords cannot avoid audits entirely. Even if the lease states that the operating-cost charge is "conclusive," court-ordered discovery might still lead the tenant into the landlord's books.

Nor should landlords take much comfort from leases that are silent on audit rights. Several courts have held that the landlord's duty to provide detailed cost statements implies a duty to permit audits of those costs. In any event, if push comes to shove, in the absence of any restrictive language, a tenant is likely to get its "audit" through court-ordered discovery.

On the other hand, the landlord should not give the tenant a carte blanche audit right. There is simply too much at stake to leave these important rights to the whim of one party or the other. But despite the potential for conflict, landlords and tenants should be able to agree on some basic questions.

Who conducts the audit?

The landlord is concerned with who conducts the audit on behalf of the tenant. What raises the most ire are contingent-fee auditors, whom landlords often view as overzealous and likely to pass audit findings from one tenant to another.

A landlord may try to avoid this problem by insisting that only the tenant or a nationally recognized audit firm conduct the audit. But unless the landlord is prepared to abide by the same restriction itself, it may insist instead — in the lease, not afterwards! — that any tenant auditor sign a strict confidentiality agreement barring it from sharing the landlord's books and records with another tenant.

What gets audited?

The scope of the audit should not be left to chance. Thus, for each charge in the lease, there should be agreement as to the right to audit, including charges for management, insurance and utilities.

The parties also may agree to submit energy disputes to a neutral engineer or specialist. In addition, if tenants pay their share based on GLA — as most tenants do — the landlord must agree to provide the tenant rosters from which the GLA share is calculated. Tenant rosters and other records and documents common to all tenants — landlord repairs, taxes, etc. — can be placed in a common, secured facility that tenants can use with a minimum of disruption to the landlord.

When can the tenant audit?

Many leases provide for limited periods in which a tenant can seek an audit, which generally range from 90 days to two years after receipt of the annual reconciliation.

While landlords may instinctively believe that the shorter deadline will result in fewer audits, it may well have the opposite effect. Tenants may err on the side of undertaking audits they might otherwise forego if they had more time.

One solution is to permit the tenant the same time to audit as the landlord is permitted for its audits. Another solution is to permit the tenant to expand its audit period — from, say, one year to three years — only if it uncovers overcharges exceeding a certain percentage.

Joint audits

For many years, diversified retailers such as Woolworth, The Limited and Luxottica have jointly audited their individual divisions. For these large corporations, obvious savings can be realized by simultaneously auditing their stores at the same location or with the same landlord. Now, unaffiliated retailers are trying to achieve the same savings, with results that may benefit themselves and their landlords.

The obvious advantage of a joint audit is shared overhead costs for auditing the same information. Landlords concerned about confidentiality need only ensure that all retailers participating in the joint audit are entitled to the same information. At the conclusion of the audit, each retailer should discuss the findings individually with the landlord, since recovery

of operating-cost charges, if any, will likely depend upon lease language that might differ from that of the other tenants.

While the advantages of a joint audit may be more apparent to retailers, their landlords may profit as well. For example, to the extent that joint audits reduce the number of individual audits, there is a proportional decrease in the landlord's time as well as distraction that audits inevitably entail.

The shared expense of a joint audit also reduces the tenant's motivation to pay contingent fees to their auditors. The result: more professional audits with more reasonable findings.

Standardization

Several years ago, a group of landlords and tenants met informally to discuss standardizing their operating-cost provisions and their bills. The goal was to help national chain retailers make sense of the dozens of different bills they receive from their many landlords. Unfortunately, the effort never got very far.

However, standardized practices with respect to operating costs should be considered again by both sides, especially in light of everyone's concern over increasing operating costs and their resulting audits.

The easier part of standardization is the bill itself. The "reasonable detail" that almost all annual reconciliations are required to show rarely looks the same from one landlord to the next. That alone engenders a good deal of confusion (and requests for audits).

The harder part is standardization of practices. According to research by the ICSC several years ago, certain charges are passed on to tenants by almost all landlords — for example, parking lot repairs and resurfacing. Other charges are passed on by some landlords but not by others — for example, rent on the marketing office, reserves for capital expenditures and home office allocations, and management fees.

The latter charges have been the subject of much landlord-tenant litigation during the past five years. The fact that they vary so widely from center to center only increases the likelihood that tenants will become suspicious of unexpectedly higher bills and will seek to audit, and perhaps litigate, their bills.

The bottom line is that audits need not be so contentious. Compromise can be the wind for the sails to set each boat on a smooth course.

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