



Operating Expense Clauses in Commercial Leases: Reviewing the Landlord's Books and Records

(Third in a Series)

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A landlord client was once accused of having a hidden agenda in his dealings with a prospective tenant. He replied sincerely, "I have no hidden agenda. I just want your money." A corollary is that once the landlord has the money, he does not want to give it back. Our first two notes (which may be accessed [here](#) and [here](#)) focused on the importance of negotiating exclusions to Operating Expenses and particularly the Capital Expenses exclusion—the one exclusion that, if negotiated correctly, can save a tenant significant amounts of money during the term of the lease.

Even the most well-meaning of landlords will have a hard time tailoring the building's Operating Expense calculations to each negotiated lease in a multi-tenant building, if the landlord tries to do so at all. More likely, the landlord will run the Operating Expense calculations without any customization and wait to see if any tenant catches that. It is up to the tenants to police the landlord.

In this Note we will focus on carefully negotiating a right to review and audit the landlord's (and its managing agent's) books and records ("Records") with respect to Operating Expenses. This is the only way for a tenant to ensure that it has not been overcharged by the landlord.

In our experience, an effective examination and audit right with respect to Records should include the following basic points:

1. The Records:

- Records should be made available in the city or, at the very least, in the state, where the property is located
- Tenant should have the right to review **all** of the Records (including, without limitation, general ledgers, invoices, payroll records, and third party contracts) with respect to Operating Expenses and make copies of the same.
- Such Records should be maintained by the landlord and available to the tenant for an extended period of time (e.g., between 3 to 7 years) following the expiration of the applicable calendar year. Of course, if a dispute is pending between the landlord and the tenant with respect to Operating Expenses for a particular calendar year, then the landlord must continue to maintain the Records until the dispute is resolved.

2. Tenant's Examination Request:

- There should be a sufficient period of time (e.g., 12 months instead of 3 months) after the receipt of the year end reconciliation statement (i.e., the year end statement that shows what the tenant paid for Operating Expenses based on estimates and the actual amount of Operating Expenses that are payable by the tenant) from the landlord within which the tenant can request the Records with respect to a particular year. A longer time period enables the tenant to avoid doing a full scale audit each year. **It is a good investment to spend the money for a high level audit every year and we strongly encourage our clients to do so.**
- There should be no restrictions on the type of auditing firm that the tenant may retain to examine and audit the Records. Landlords will insist that the auditing firm cannot be compensated on a contingency fee basis (i.e., where the auditing firm receives a percentage of the savings that it finds for the tenant) and must be a regional or national size firm. The landlord's goal is to increase the tenant's costs and thereby decrease the likelihood of an audit. A tenant wins if it can negotiate the greatest degree of flexibility in choosing its auditor. **Many auditing firms are compensated on a contingency fee basis. One compromise is for the tenant to have the right to use a contingency fee auditor so long as that is the prevalent method of compensation in the industry.**

3. The Audit:

- There should be a longer period of time (e.g., 120 days instead of 30 days) in which to report the results of the audit to the landlord after a request has been made to review the Records. If Records need to be reviewed at a specific location, if the landlord will not allow copies to be made, or if the person preparing the Records is not available, all can eat into the time period for completing the audit.
- If the audit shows that the landlord overbilled by at least a certain percentage (e.g., more than 5%) (either in the aggregate or a line item basis), the tenant should have the right to go back and review Records (or just the particular line items with respect to which there was overbilling) from prior years when no audit was conducted to determine whether there was also overbilling in those years.

4. Resolution of Disputes:

- In most cases, unless the overbilling is blatantly obvious, the landlord will challenge the audit results. The dispute should be resolved by independent auditors acceptable to both parties. Litigation is time-consuming and expensive. The parties may consider expedited binding arbitration to resolve the dispute.
- While the dispute is being resolved, the tenant should have the right to offset one-half of the disputed amount against the rent next due. Once the dispute is resolved, appropriate adjustments can be made.

5. Payment of Costs:

- In general, the cost of the audit is borne by the tenant since the tenant initiated the audit. However, it is fair and reasonable to request that, if the audit shows that the tenant was overbilled by a certain percentage (either in the aggregate or on a line item basis), then the cost should be borne by the landlord.

6. Other Tenants' Audits:

- In the event another tenant of the building performs an audit of Operating Expenses and such audit reveals that such tenant was overbilled by the landlord for specific Operating Expenses or was incorrectly charged for an expense(s) as an Operating Expense, then the landlord must disclose such information to you and re-calculate your responsibility for Operating Expenses. **This falls in the “nice to have” category instead of the “must have” category.**
- The procedures, if any, that a landlord's draft of the lease provide for the tenant to challenge the landlord's calculation of Operating Expenses are designed to be difficult for the tenant, similar to making a health insurance claim. Carefully negotiating the right to examine and audit the Records is the only way to make sure that the time and effort spent negotiating the Operating Expenses exclusions is productive. You don't need to get each of the above provisions in your favor in order to save yourself money. You just need enough to let the landlord know that you are watching.

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Shane specializes in commercial real estate. In particular, he focuses a substantial portion of his time on commercial leasing matters on behalf of both landlords and tenants throughout the United States. In addition, on behalf of our clients he has purchased and sold real property of an aggregate value well into the hundreds of millions of dollars, including apartment complexes, office buildings, and mixed use industrial/office/warehouse properties, and has assisted our clients in the financing and refinancing of such properties.

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