MAJOR TENANTS BEING OVERCHARGED BY LANDLORDS

COPY

Audits Find Widespread Lease Abuses

by Terrence Belford

Some tenants in Canadian office buildings may be paying hundreds of millions too much in rent.

As a growing number of major tenants are scrutinizing their costs, some are finding that landlords by error or design are overcharging them, according to the companies hired by them to audit their leases.

"We are easily looking at hundreds of millions in overcharges across Canada," says Rick Goldberger of Commercial Lease Advisory Services Inc. in Thornhill.

"With a major national concern with multiple offices across the country the overcharges can be in the tens of millions," adds Kim Fairweather, of KC Financial Inc. and formerly a partner in KP Financial Group Inc. of Markham, Ont.

Both men represent a new and thriving subset of the real estate industry. Their companies are retained by tenants to conduct a thorough audit of where lease money is going; especially that portion devoted to covering shared operating costs. Both are finding evidence of wide-scale overcharges by landlords.

"I would guess between 90 per cent and 95 per cent of my clients see some form of recovery," Mr. Fairweather says. Mr. Goldberger, a sole practitioner, says his findings are similar. "Not all of them always go for recovery though," he adds. "Landlord-tenant relationships are special and in some cases tenants don't want to upset landlords. They may forgive what is owed and just look towards paying what is really due going forward."

The largest recovery Mr. Fairweather's company ever won for a tenant was $50 a square foot in overcharges. Mr. Goldberger says his largest find totalled more than $500,000 for a 26,000-square-foot office. Neither will name the tenants involved.

"Landlords regularly make non-disclosure agreements part of any settlement," Mr. Fairweather says. "In fact, what I see happening now is they also demand tenants sign another non-disclosure agreement, which prevents the tenant from even saying an audit took place at all."

Landlords are also pressing to include clauses in new leases that preclude tenants from conducting audits ...

The list of major tenants known to have conducted audits is growing. RBC Dominion Securities, TD Canada Trust, Via Rail, Imperial Oil, the Toronto Stock Exchange, Manulife Financial, the Canadian Institute of Chartered Accountants and even the City of Toronto have all done lease audits.

Few Canadian landlords will talk publicly about lease audits. Cadillac Fairview Corp., the Oxford Properties Group and GWL Realty Advisors Inc., and the Canadian Institute of Public and Private Real Estate Companies (CIPPREC) all refused comment on lease audits.

Philip Mostowich, senior vice-president, eastern region, for Brookfield Properties Corp, however, said lease audits have become "a fact of life" for major landlords.

"Large tenants feel this is one of the ways to ensure they are being fairly treated under the contractual terms of leases. We try to ensure that we always comply," he says. "I can't speak for other landlords but it is important for us to live up to the terms of leases."

Mr. Fairweather ranks Brookfield as the best landlord in Canada to deal with but refuses to name the worst.

"Let's just say there are a lot of them."

Major offenders tend to be landlords with large core properties commanding high operating costs, explains Mr. Goldberger. Most commercial and retail leases have two components. There is the net rent, calculated on space occupied, plus a share of operating costs for the entire building, according to a percentage of the overall space they occupy. Buildings with relatively low operating costs are unlikely to see them overstated.

"We have very little experience with lease audits," says Michael Emory, president of Allied Property REIT, which holds a significant portfolio of office space in less expensive former industrial buildings west of Toronto's downtown core. "Our base rents are between $12 and $20 a foot and operating costs another $8 to $10. If you save 10 per cent through a lease audit, that only works out to 80 cents a foot.

"Big towers are a different matter. Their operating costs can be $24 a square foot. Save 10 per cent on that and the savings are significant."

The reasons for the overcharges vary widely, Mr. Goldberger says.

"Some are through simple mathematical error, some are through differences in lease interpretations, some through aggressive accounting and some because of the pressure to improve the bottom line," he says.

Mistakes that result in tenants being overcharged may well stem from the nature of commercial real estate itself, suggests Pierre Bergevin, vice-president of corporate services at Royal LePage Commercial Inc. In soft markets where vacancies are high, landlords can veer from standard leases and offer concessions to prospective tenants. Those deviations do not lend themselves to management through automated processes and mistakes can be made, he says.

"Once you stray from normal procedures it becomes so easy to overlook things," adds John O'Toole, executive vice-president of CB Richard Ellis Ltd. "In any building you can name there is an enormous variation in lease terms and conditions. Errors in calculations can easily slip in."

Mr. Fairweather and Mr. Goldberger also suggest the method used to compensate many property managers favours overcharging. Many are paid a fee based on a percentage of gross rental revenues collected – base rent plus operating costs – or a percentage of operating costs.

"Both those approaches favour bumping things up, not reducing them," Mr. Goldberger says.

Mr. Fairweather has seen situations where a property manager of a building only half occupied charged tenants against the contract for electricity as if the building would have been fully leased. In another situation, Mr. Goldberger won a settlement for a tenant operating a nine-to-five operation yet paying the same electricity costs as another tenant that ran its business around the clock.

Many tenants are regularly charged a share of federal and provincial capital tax charges despite court rulings that say the landlord alone must bear that charge.

Both also say that some landlords they have found overcharging one tenant seldom correct similar overcharges for others in the same building.

"It is not to their benefit, so they don't," Mr. Fairweather says. He suggests that is one of the reasons for the non-disclosure agreements. He believes they don't want tenants knowing they are being overcharged, he says.

Landlords are also pressing to include clauses in new leases that preclude tenants from conducting audits, both lease auditors say.

"Unfortunately, the only tenants which can resist demands like that are large ones with a lot of financial clout," Mr. Goldberger says. "Small tenants just don't have the weight to either resist no-audit clauses or to afford to hire lease auditors in the first place."

Nor can they easily find lease audit firms to represent them. Mr. Goldberger, for example, looks for clients with at least 20,000 square feet of space. Mr. Fairweather's clients are larger. The standard fee for lease audits is about 40 per cent of the historical overcharges plus 20 per cent of future savings to the end of the lease.

"There is a real bidding war for business under way today," Mr. Goldberger says. "The big brokerages all offer the service as a way to establish relationships with clients. As a result they will underbid the independents like us ... I have seen them go as low as 25 per cent."

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A Lawyer's View of Lease Audits

by Roy A. Nieuwenburg,
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Lease audits have their place, but in my experience, large tenants are not inclined to carry out wholesale audits of their leases. Rather, they would be inclined to do so only for those leases in their portfolio where something has tweaked their concern, or if they had not received satisfactory answers to their questions when they have scrutinized the reconciliation of operating costs they received from the landlord. I would advise against broad "fishing expeditions."

Generally, a sophisticated tenant would be cautious about using these kinds of services because, despite

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who conduct all kinds of communications through the ubiquitous portable e-mail devices.

"You mean they broke into the PIN messages, how did they do that?" gasped one Bay Street lawyer and frequent BlackBerry PIN user who declined to be identified.

The CIBC isn't saying how it accessed the BlackBerry messages, but states in its lawsuit that the executives "seemed to have believed [they] did not create any record of their e-mails on the [Bank's] central computer systems."

Some BlackBerry devices enable users to engage in direct communications outside a central mail server when PIN numbers are exchanged.

Technical experts, however, said systems are available that allow employers to store or download employees' BlackBerry e-mails when the devices are employed to tap into the office e-mail server to retrieve regular e-mails.

"Employees need to be reminded that whether you are using BlackBerrys or web-based e-mail addresses to send mail, their employers still have access to the traffic," said Michael Geist, a University of Ottawa professor who specializes in technology law.

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whatever the black and white of the lease says, there are a lot of factors that figure into the long-term relationship. Even though there might be some recovery, the relationship will likely be strained, which could cost in other ways in the long run. Landlords are not fond of these "lease audit" companies, and would likely not welcome them with open arms. As a tenant, once you've authorized a lease audit company to be your representative (especially in a shared-recovery arrangement), you lose some control. The lease audit company might be willing to be more aggressive or abrasive, in their zeal, than you might be inclined to be. You might have trouble calling them off, and dealing with any damage done to your relationship with the landlord.

The landlord/tenant relationship covers a lot of territory, and the operating costs issue usually isn't always the paramount consideration. Past dealings on these kinds of issues might creep into other negotiations. There is give and take in the relationship, and that goes both ways. A tenant might not want to upset the landlord, because the tenant needs to extend the lease beyond contracted renewals. Or the landlord and the tenant might be coming up to a rent review or rent renewal negotiation. Saving half a dollar a square foot on operating costs, after a grind with the landlord, might cost you a dollar a square foot in the next negotiation of the base rental rate. Going the other way, a landlord looking at possible vacant space at the end of a lease term also wants to keep an incumbent tenant happy, and if there is a genuine issue over operating costs and taxes, then, regardless of what the lease says, it might make sense for the landlord to come to peace with the tenant on the operating costs issue (which would otherwise be an irritant).

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Given these considerations, as stated in the *Globe and Mail* article, not all tenants go for recovery, even if they are persuaded that there might be a claim.

For the tenant, likely there will be a lot of administrative time and sometimes legal expenses involved (e.g., reviewing the lease provisions, demanding that records be produced, etc.) in carrying out these audits. Leases frequently stipulate that there is a time limit for how far back the tenant can go. In a landlord-friendly lease, the time limit would be, say, one year. This strongly dissuades tenants from conducting an audit. If the tenant establishes that an error has been made, or is convinced that an item has clearly been overcharged for many years, but can only recover going back one year, then the "cost/benefit" is not there.

In extreme cases, such as when a tenant thinks it has been intentionally cheated by the landlord, then the tenant might choose to go after it – and in that kind of case, a "one-year limit" might not save the landlord. The tenant could argue misrepresentation or deceit (i.e., fraud), which would trump a "time-limit" clause, but it is difficult to establish.

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