FIXED FEE LEASE CHARGE ERROR CONSULTANTS VS. CONTINGENT FEE CONSULTANTS

by Theodore H. Hellmuth

The old KISS (Keep it Simple Stupid) principle applies to modern real estate transactions as it does to everything else. Violate this principle and dispute is imminent. An example which has been much in the news relates to calculations of amounts due under adjustable rate mortgages. Significant error easily arises in such calculations because the concepts underlying adjustable rate mortgages are inherently complex. A similar potential for error exists in the assessment of rent under commercial leases.

There already has been considerable recrimination over ARM calculations.[1] A similar, or greater, potential exists for dispute in connection with lease calculations. At least one company has taken dead aim at this latter issue. According to published accounts, this company is training associates from throughout the country to solicit tenants on a 50% contingency fee basis to challenge rent charges, particularly regarding common area maintenance (CAM) assessments and square footage calculations.[2] Presumably, if initial lease rental and charge audits are successful, the successes will breed competition and the popularity of lease charge audits will increase.

Modern commercial leases tend to be complex documents. Among their complexities are numerous subtleties relating to the rent to be charged. The simple days of fixed rent as the tenant's major occupancy expense are long gone. Rent escalations, often designed not only for present property configurations but also for dimly perceived future changes, are a way of life. In addition to escalated rent, commercial leases routinely incorporate complex formulas by which the landlord seeks to pass on to the tenant many of the financial risks attendant upon price increases for services which landlords provide to the commercial tenants.[3]

All the ingredients are in place for rental and lease charge errors to occur. As is true of any complex system, there is a lot of room for error in the asessment of the varied charges which make up the package of obligations labeled "rent" in a typical commercial lease. This potential for error magnifies as landlords and tenants change management structure, wash through bankruptcies and insolvencies, and experience turnover in key personnel.

Shifting agendas and practice, management error and clerical mistakes are not the only sources of

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The article is extracted, with modification, from an upcoming book to be published in 1994 by Statelaw Guides, Inc. The book is preliminarily titled American Handbook of Rent and Lease Charge Analysis.

problems in connection with the proper assessment of rent. In some instances, the rent structure in commercial leases is sufficiently obtuse to attribute the problem not to lease administration, but to lease language. Lengthy lease documents often include language which creates an ambiguity in a given instance. Worse, a lease may contain an outright error, either in concept or in phraseology. In any case, landlord and tenant may not discover the problem until after some significant delay, thereby heightening the problem and creating the potential for the multiplier effect to turn a manageable problem into a much more serious situation.[4]

Knowledgeable tenants with multiple retail locations have long realized this potential for error, whether it be in drafting or administration, and have had their leases audited from time to time to assure they are accurately assessed.[5] Other tenants follow a more simplistic approach, only challenging assessments when they seem out of sync with historic practices.[6]

It should not be thought, however, that all errors are made by landlords in their own favor. Significant errors may be made by a landlord in the tenant's favor, which the landlord may identify on a self-audit or a defensive audit following the tenant's claim for reimbursement of another error. Indeed, landlords are not the source of all errors in rent charges. The landlord is usually the party who formulates CAM charges and cost of living (CPI) escalations. However, the landlord of a retail facility will often have very little or nothing to do with calculation of percentage rent, which typically is based on calculations by the tenant and may include significant error.[7]

Hard Times Breed Contingent Fee Error Discovery Consultants

Prevailing adverse conditions in the economy have created two situations which tend to shed more light on the phenomenon of error in assessment of rental charges. The first situation has to do with the renewed focus on cost reduction by many tenants and landlords alike. The second relates to the structural unemployment problems in the economy. Structural unemployment puts a regrettable number of talented and energetic people out of work or causes them to lose full employment. These talented people may have prior job experiences which enable them to know that error generated by lease complexity offers a potential source of revenue. If they do not have any background in this area, there are others who can help them out.

One approach to generating revenue from errors in rent calculation is for consultants to sell services to tenants on a "can't lose" basis. The pitch to the tenant is that the consultant will investigate the tenant's leases and discover any errors in square foot measurement, CAM charges or otherwise. Although the arrangements under which the consultants operate can vary considerably in detail, the outline for a contingent rent and lease charge analysis consultancy arrangement is not hard to develop.

Contingent Fee Contracts Are An Easy Sale

The old saw urges one to "sell the sizzle, not the steak." Contingent fee lease charge error consultancy contracts claim the most compelling sizzle of something for nothing. This makes such contracts a relatively easy sell. It is always easy to hype the alleged risk-free nature of these contracts. Unfortunately, few things are truly risk-free.

Typically, contracts for contingent fee lease charge error analysis will be quite brief. Brevity minimizes sign-up resistance grounded in legal phobia. If the consultant agrees to perform an analysis without risk to the tenant, the consultancy arrangement will likely provide that the consultant only recovers a fee if he is able to collect an overcharge from the landlord. Typically, consultants receive a hefty percentage, say 50%, of any recovery made. In some cases, a consultant will require the client to pay some amount of the consultant's out-of-pocket costs.

Contingent fee consultants justify large contingent fees on the basis that they are taking the risk of working in vain and of being unable to recover any money for the client and thus nothing for themselves. They further justify the fee on the theory that they only earn a fee if they create value. Absent the contingent consultant's successful intercession to alert his principal to challenge lease assessments, the tenant would have continued to make payments under his lease as he did previously.

Such contingency arrangements have been in existence for years. Contingent fees of 50% of savings, if any, are quite common for businesses that contest real estate tax charges on a contingency basis. Similar arrangements are promoted by consultants who analyze utility bills for overcharges. In the context of leases, one can visualize tenants' consultants who specialize in challenging assessments by landlords and landlords' consultants who specialize in contesting percentage rent calculations by tenants. Either could charge a contingent fee of 50% of the amount saved, with no recovery if no savings occur.

Fixed Fee Service Arrangements Are Preferable For Clients

Contingency fee lease charge error consultancy contracts have different types of risk for the client. They carry the obvious risk that the client will pay a substantial amount for minor efforts by the consultant. This would occur if a consultant reviewed a lease, quickly discovered a major error and was able to convince the landlord to settle it without undue delay. This risk is open for all to see and should not be a cause to object to contingent fee arrangements. In fact, many tenants might hope this was the case, although it might diminish as the consultant claimed his bounty, not only for past years in which the error appeared, but also in all the remaining lease years to which the consultant might claim the fee under the contingent fee arrangement.

There are other less obvious risks which can beset those who succumb to the blandishments of

something for nothing. It is these less obvious risks which underlay the thesis of this article, that contingency fee lease charge error discovery contracts are undesirable for principals. Such contracts are filled with potential for conflict and legerdemain, all to the client's disadvantage. Insolvent clients have no choice. If they are going to hire a consultant, it must be on a contingent basis. Given the choice, clients not facing insolvency should opt for fixed fee consultancy agreements.

This is not to say there is anything inherently illegal or disreputable about contingency fee error discovery consultancy agreements. Absent state or local law restrictions and assuming the consultant is not acting without a license to perform a function requiring licensure, contingency fee lease charge consulting usually is perfectly legal. Being legal and being sensible for the client are not necessarily the same thing.

Once the sale (i.e., execution of the contingency consulting contract) is achieved, principals often will begin to appreciate the potential problems inherent in contingent fee lease charge error analysis. There are significant opportunities for disagreement inherent in contingent fee arrangements of any kind. Contingent fee lease charge error discovery consulting contracts are particularly difficult.

Appropriate Role For Contingent Fee Contracts

Certain types of contingent fee contracts are inherently less subject to abuse than others. For example, typical listing agreements, whereby the broker receives a commission of less than 10% of the sale price of the property, are a proven acceptable type of contingency contract. Both the broker and the seller have similar motivations to sell the property. In the vast run of transactions, the respective duties and performance of the parties are well understood. Seldom will an event occur which severely tests the commonality of the sales goal in a way which effectively causes the broker to work against the interests of the client.

Just because certain types of contingent contracts are appropriate does not mean that other similar types of contingent agreements make sense. For example, change the arrangement from the standard 1% to 10% fixed contingency listing fee and you can dramatically alter the mix of motivations, even in a listing contract.

Net listing contracts, which are agreements whereby a broker convinces a client to permit the broker to keep all or some substantial percentage of the excess over a predetermined sales price, have engendered huge abuse over the years. They have caused sufficient controversy for many states to have outlawed such arrangements.[8] A principal difference between normal listing agreements and the trouble-prone, often illegal net listing agreement is the very high percentage participation (often 100%) which the broker realizes on any sale price over the net listing amount.

Real Estate Tax Contest Contingency Contracts Are Appropriate

One cannot isolate any single factor as the one element which causes problems. High percentage realization does not always measure the difference between a contingency arrangement which works and one which offers pitfalls. For example, contrast a contingent fee real estate tax consultancy agreement with an agreement for contingent fee lease charge error analysis. Assume the agent's percentage recovery in both instances is 50% of the savings for some stipulated period of time. A contingent fee real estate tax consultancy agreement is far less likely to result in conflict between agent and principal than is a contingent fee lease charge error discovery arrangement.

The real estate tax consultant makes the claim for tax reduction to a public bureaucracy which expects a significant number of taxpayers to challenge the assessment. This means that the process will not have a tendency to be tendentious. Tax assessors have only one task, tax assessment. Make one mad and you have little risk. If a hired tax consultant legitimately angers the assessor, or more likely someone on his staff, the prospect for meaningful revenge is slim. Further, the process of tax appeal usually has a predictability, if not of outcome at least of procedure. The process of challenging a tax assessment is usually governed by state law. It has a definite beginning, middle and end. Most commercial property owners have a basic familiarity with the controlling issue in such a real estate tax challenge which deals most often with the single issue of property valuation.

Lease charge error analysis is a far more uncertain task. Even in these times when tenants are king, the landlord-tenant relationship is a delicate one. Neither party can afford to gratuitously irritate the other. Tenants should think twice before hiring a gunslinging stranger to challenge the income stream which the landlord is getting from his property. This is particularly so if the stranger has a contingency contract, which means the consultant may claim a vested right to continue a challenge even if the tenant is not fully agreeable.

It makes sense that the higher the contingency fee, the greater the risk for dispute between principal and agent. From this standpoint, a contingency lease charge error fee of 50% is easily of sufficient size to foster disputes. This potential for dispute drops in degree when lease charge error consultants charge a significantly smaller contingency amount as a fee. The size of the contingency is not, however, the only issue, as is clear when one compares the potential for dispute between clients who sign up for a 50% real estate tax reduction consultant as opposed to clients who sign up for a lease charge error consultant.

Specific Problems With Contingent Fee Lease Charge Error Contracts

Other issues which make contingent fee lease error challenges riskier for the principal are not hard to

catalogue. Obviously different contract forms will have these risks in differing degrees. However, all lease charge error contingency contracts should be analyzed based on the following points:

1. Contingent fee lease charge error consultants have significant incentive to oversell the "no risk" aspect of the arrangement. In fact, the client risks severe damage to his landlord/tenant relationship if an overly aggressive consultant overstates the client position or if the consultant acts in a way the client otherwise finds objectionable.
2. The landlord/tenant relationship involves many potential deals which lack obvious price tags. If a landlord wants to settle out tenant's challenge to the landlord's lease charges, the landlord may prefer a noncash quid pro quo, such as relieving the tenant from a burdensome lease covenant. This type of arrangement is easy to work out when a fixed fee consultant is involved, but is not easy to do when a contingent fee consultant enters the picture.
3. Even in cases when a landlord tries to settle a tenant lease charge complaint with cash which can be easily divided between the tenant and the consultant, it may be unclear as to whether this cash is new money or is money which the landlord had budgeted to use as a rent concession for the tenant to induce renewal of the lease or for some other purpose.
4. The decision of how hard to push and when to settle can easily be skewed in a contingent fee situation in which the consultant has an incentive to score quickly and often, even if the amounts are less than might be obtained if the incentives were placed differently. The risks may go either way. The consultant may push too hard or not hard enough. In either case, the consultant is going to want some degree of control because of the contingent fee. In a fixed fee scenario, the principal has a much greater degree of control.
5. The best defense is a good offense. A contingent fee consultant's aggressive assault may breed a counterclaim by the landlord, resulting in the potential that the consultant will recover 50% of his client's positive recovery, while the client is responsible for 100% of any liability which the other party uncovers.

There are likely to be many specific examples in which a principal engages a contingent fee error discovery consultant without encountering any of the listed problems. Nonetheless, principals who wish to hire a consultant to analyze their leases for proper assessment of rent and charges are far more likely to have a satisfactory arrangement if they hire a professional consultant for a fixed fee. In most instances, hiring a consultant for a fixed fee will avoid the most perplexing of the problems set out in this article.

The Game Merits A Fixed Fee Consultant

Fixed fee lease charge error consulting contracts need not expose the principal to a major unrecouped fee, even if the consultant's fixed hourly rate is quite high and even though the principal owes the fee regardless of results.

A knowledgeable consultant with experience should be able to assess quickly the potential for recovery in a given situation. Once this is done, the consultant can advise the client of the cost to pursue the matter further and the likelihood of success. The client then can decide whether or not it is worthwhile to proceed further. The client can monitor the situation as it proceeds and fire the consultant without penalty when he wishes to do so, effectively cutting off any responsibility for additional fees.

In most cases, lease rent and charges involve significant expenses for a tenant. If this is true for one year, how much more is it true when one considers the multiplier effect. If a landlord has mischarged a tenant for one year or if the tenant has misrepresented percentage rents for one year, chances are similar errors occurred in past years and are quite likely to occur in future years. If such is true, then the amount in issue becomes multiplied by the number of years involved. This can quickly add up to serious money, even if the amount for a single year is not considerable. Add interest and you really have something to think about. Therein lies the rub. The best way to proceed should be determined by the principal, unfettered by large contingent claims by a contingent fee consultant. This is why fixed fee consultants are preferable.

NOTES

1. Kobliner, Beth. "Avoid the Pickpocket Bank's Wrong ARMS and Round HELs", *Money*, vol. 22, p. 43 March 1993; Forster, Eric. Are ARM Borrowers Overpaying? 25 *Real Estate Today*, Vol. 25 Sept. '92 p. 27.
2. Dekok, David. "Measuring Up, Firm Checks Leased Space Dimensions", Harrisburg, *The Patriot*, Vol. 152, March 29, 1993, p. 1; "Four Partners Thrive Offering A Service That Every Commercial Tenant Needs!" *Opportunity Digest*, March, 1993, p. 39.
3. *See e.g. LaSalle National Bank v. Service Merchandise Co.*, 827 F.2d 74 (7th Cir. 1987) (*LaSalle* sets out the complexities of CAM assessments as they appear in a modern shopping center lease.)
4. The multiplier effect comes into play when an error which has recurred for a number of years multiplies for each of those years, often with interest added. *See e.g. Goldstein v. City of St. Louis*, 552 N.Y.S.2d 594 (A.D. 1 Dept. 1990).
5. The rationale behind an ongoing policy of lease charge audit is reviewed in Jeffrey Newman, "Common Area Costs—The Hidden Rent", Winter, 1990, *Real Estate Review*. For tips on the hazards of doing self audits in the area of ARMs, which are applicable in many instances to lease charge self-audits see Gary Tepper, "Don't Compound ARM Errors with Misguided Audits", *ABA Banking Journal*, Vol. 83, Nov. '91, p. 24.
6. *See e.g.* "Commission Cautions Consultants", June 1993, *Missouri Real Estate Commission Newsletter*, p. 3, which states: "The functions of a real estate consultant are not always completely clear, and those who operate in that capacity can very easily step into the arena of licensed activities . . . "
7. *See e.g. Michigan Ave. National Bank v. Evans, Inc.*, 531 N.E.2d 872 (Ill App. 1 Dist. 1988) (Landlord forced tenant to include wholesale sales in percentage rent calculations.)
8. *See e.g.* Missouri Real Estate Commission Regulations §250-8.090.