

**COUNTY OF CARLETON LAW ASSOCIATION**  
**23<sup>rd</sup> ANNUAL EAST REGION SOLICITORS CONFERENCE**  
**May 26 & 27, 2017**

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**LEASE AUDIT RIGHTS**

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I would like to express my appreciation and thanks to Megan Reilkoff for her assistance in preparing this paper.

April 19, 2017

## Introduction

There are typically two instances in a commercial lease that have the potential to involve an audit by one of the parties of the books and records of the other. The first is the landlord's right to audit the tenant's books and records to confirm the tenant's reported gross sales and revenue statements. This right is typically included in retail leases where the tenant is required to pay percentage rent; that is, rent based upon a percentage of the tenant's gross revenue. Because the form of lease is usually prepared by the landlord, this audit right is included in almost all percentage rent leases. The second kind of audit right is in favour of the tenant and relates to the right to audit the landlord's books and records to confirm the landlord's statement of operating costs. This is almost never included in the landlord's standard form of lease and must be requested by the tenant as part of its lease negotiations.

This paper will focus on tenant audit rights and discuss the elements that should be considered when negotiating the scope and terms of tenant audit rights in a lease.

## Tenant Audit Rights

The right to audit the landlord's books and records to confirm the additional rent or operating costs charged is an increasingly common lease amendment requested by tenants. Many landlord statements only summarize what is owed by the tenant and do not contain sufficient detail to allow the tenant to verify that the amounts charged to the tenant have been calculated and charged in accordance with the lease. A prudent tenant with sufficient bargaining power will want to negotiate into the lease provisions that require the landlord to deliver detailed statements that reflect the various exclusions and/or deductions contained in the lease, that give the tenant the right to request back-up material, including copies of invoices, receipts and records relating to the amounts charged to the tenant, and that give the tenant the right to audit or review the landlord's books and records relating to operating costs.<sup>1</sup>

While this appears to be a reasonable request, in the hands of the unreasonable or the overzealous, it can quickly degenerate into a major headache, if not a substantial unrecoverable loss on the part of the landlord.

Only the naive would say no errors are ever made in the allocation of operating costs in a commercial development. No system, no matter how carefully and rigorously applied, can assure the landlord's operating costs are beyond reproach by any of its tenants. Landlords can only hope to ensure that costs are judiciously incurred, reasonably allocated and that the inevitable mistakes are small enough to be immaterial to either party.

The very fallibility of the allocation of additional rents underscores the reasonableness of a tenant requesting that it be granted the right to confirm the operating costs statement by reviewing the landlord's books and records in this regard. No problem thus far.

Difficulties arise when information obtained by a tenant in the audit process is shared with other tenants of the landlord. A minor error can, by compounding, escalate. Problems also arise when tenants are induced to retain an audit consultant on a contingency fee basis to "see what they can get". What is of no cost consequence to the tenant can become a major headache for the landlord if for no

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<sup>1</sup> Julie Robbins, "Where's my money? Drafting, negotiating and reconciling additional rent clauses in retail leases", June 4, 2015, online: <http://www.lexology.com/library/detail.aspx?g=427c7f78-7029-4cc1-9bed-801900df4e57>.

other reason than its nuisance value. The contingency retainer also tends to involve certain other problems such as tenants disputing a landlord's statement but not giving any specific grounds or detail about the dispute. I have in my practice seen a tenant dispute the operating costs for numerous years by merely sending the landlord a notice that it disputes such operating costs. No grounds, no details.

The Landlord's best line of defence against unreasonable and excessive lease audits is to negotiate and arm the lease with audit clauses that circumscribe the tenant's audit right and subject it to strict conditions.<sup>2</sup> If a tenant asks for audit rights, I suggest that the landlord and tenant and their respective legal counsel have regard to the following considerations in negotiating this right. The landlord and the tenant may have opposing, and often equally reasonable and compelling, views on many of these issues. For this reason, I propose to address each consideration from both the landlord's and tenant's perspective, where possible.

### **Negotiating Tenant Audit Rights**

#### **1. Make payment in accordance with the statement a precondition to the audit right.**

**The Landlord's Perspective:** The lease should require the tenant to pay its additional rent and operating costs in accordance with the landlord's statement unless and until the audit proves the statement to be in error. In fact, the payment of the amount shown by the statement to be owing should be a precondition to the tenant's exercise of its audit right.

**The Tenant's Perspective:** While the right to withhold payment will give the tenant significant leverage to compel the settlement of the amounts in dispute, only a tenant with a lot of leverage is going to be able to negotiate this right. This will be very vigorously opposed by a landlord.

#### **2. Audit requests should specify the suspected errors in reasonable detail.**

**The Landlord's Perspective:** The landlord should require the tenant to specify in reasonable detail the nature and grounds of the disputed items. Otherwise, the tenant will be able to circumvent the prescribed time limits by merely advising the landlord that it disputes the statement. This will also help prevent the tenant and its consultant from turning the audit into a 'fishing expedition'. Equally importantly, this will permit the landlord to respond to the tenant's concerns, and hopefully avoid an audit altogether.

**The Tenant's Perspective:** This will be a difficult test for the tenant to meet if its lease does not require the landlord to provide a reasonably detailed statement of operating costs. If the landlord is permitted to deliver a statement that merely states the amount owing by the tenant, it will be very difficult, if not impossible, for the tenant to detail its dispute. Again, I suggest that it is important for the tenant to negotiate the form of the statement and the level of detail to be provided by the landlord. Otherwise,

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<sup>2</sup> Paul Mayer, "Lease Audits", 2005 eSpace Montreal Vol. 15, No. 2, online: [http://m.fasken.com/files/Publication/447ad729-09df-456c-89d3-43a58865a987/Presentation/PublicationAttachment/66492df5-f639-451f-813d-443bc559dbc5/LEASE\\_AUDITS.pdf](http://m.fasken.com/files/Publication/447ad729-09df-456c-89d3-43a58865a987/Presentation/PublicationAttachment/66492df5-f639-451f-813d-443bc559dbc5/LEASE_AUDITS.pdf) and "W5: Setting Limits on a Tenant's Right to Audit Leases", 2005 eSpace Montreal Vol. 15, No. 3, online: [http://m.fasken.com/files/Publication/7587650a-91d6-47f9-918d-6b97071fd67e/Presentation/PublicationAttachment/b07ada18-2023-4b54-bccc-6fd7a1fb0aa5/W5\\_SETTING\\_LIMITS\\_TENANTS\\_RIGHT\\_TO\\_AUDIT.pdf](http://m.fasken.com/files/Publication/7587650a-91d6-47f9-918d-6b97071fd67e/Presentation/PublicationAttachment/b07ada18-2023-4b54-bccc-6fd7a1fb0aa5/W5_SETTING_LIMITS_TENANTS_RIGHT_TO_AUDIT.pdf).

the only ground upon which the statement can be disputed will be the tenant's feeling that the amount charged is simply too high. In addition, it will not be in a position to give any sort of instruction to its audit consultant as to where to focus its attention.

If the landlord will not negotiate the form of its statement, it is both reasonable and advisable prior to signing the lease, for the tenant to request a copy of the landlord's previous year's reconciliation statement. In fact, it is my practice while negotiating the offer to lease for a tenant, to require the landlord to provide to the tenant the landlord's statements for the 3 years predating the offer to lease. This will enable the tenant to satisfy itself with both the form of the landlord's statements and, perhaps more importantly, the historic per square foot occupancy costs for the property to confirm that the landlord is not 'low-balling' its operating cost estimates for the purpose of securing the tenancy.

### **3. Add a Drop Dead Date.**

**The Landlord's Perspective:** A tenant wishing to dispute the landlord's operating cost statement should be required to do so promptly; that is, within a specified period of time after receiving the landlord's statement. Time limits vary but typically an office tenant is given between 60 and 90 days after delivery of the landlord's statement to advise the landlord that it disputes the statement and has elected to exercise its right to audit. Retail tenants may be able to negotiate a longer time limit – anywhere from 60 days to 6 months - because they can argue that they should have the same period of time as is given the landlord to audit the tenant's gross revenue records.

The lease should provide that if the tenant does not dispute the landlord's statement within the prescribed period or should it fail to exercise its right to audit the landlord's books and records within the required timeframe, the tenant is deemed to have accepted the landlord's operating cost statement. This permits the landlord to close its books with certainty for the fiscal period in question.

**The Tenant's Perspective:** While the tenant will wish to avoid the imposition of any time limits on its dispute and audit rights, it is likely going to agree to some limitation. The tenant should ensure, however, that the prescribed time periods are sufficient to permit it to properly consider the landlord's statement and to decide whether it wishes to dispute the same. (It should also be noted that large national tenants often require unlimited or very extended time limits – anywhere from 7 years to the whole term of the lease - so as to permit them to audit their landlords on a rotation basis.)

### **4. Prohibit Contingency Fee Based Audits.**

**The Landlord's Perspective:** If at all possible, I suggest that the landlord require that the tenant's audit consultant be a qualified, professional auditor from an independent [many landlords require "a nationally recognized"] firm of chartered professional accountants. In addition, the lease should provide that the tenant may not use an audit consultant charging on a contingency fee basis. Generally speaking, this kind of retainer contemplates payment based on a percentage of any overcharges discovered. In contrast, a fixed-fee auditor does not have a financial interest in the results of the audit. As there is no up-front cost to the tenant if the audit is being carried out on a contingency basis, cost will not be a disincentive to the tenant's election to challenge the landlord's statement of operating costs. In fact, because there is no cost consequence to the tenant, the tenant is likely to request an audit even if it has no reason to believe that the landlord's statement is inaccurate. In addition, if the audit consultant's payment depends entirely on finding overcharges, it has no reason to act reasonably. It has no long term relationship with the landlord at stake. The likelihood of a total "fishing expedition"

greatly increases and one often gets the sense that the purpose of the exercise is to wear the landlord down by tying up its personnel for extended periods of time with a view to negotiating a settlement not necessarily based on any concrete misallocation or mischarge, but on the landlord's desire to bring the exercise to an end.

**The Tenant's Perspective:** When a tenant is deciding whether or not to endeavour to negotiate for an audit right, it needs to take into account what it will cost to carry out the audit. There is no point negotiating to include a right that will be cost prohibitive to exercise. Often, it will be more cost effective for the tenant to negotiate the form of the landlord's statement, and more particularly, the level of detail to be included in the statement. In this way, the smaller tenant (for whom an audit right is not cost effective) can ensure that the few potential high dollar amount line items that are to be excluded from its operating costs, are in fact being excluded.

#### **5. Ensure that all information is kept confidential.**

**The Landlord's Perspective:** It is important that information resulting from, or gleaned during the course of, the audit be kept strictly confidential. To this end, both the tenant and its audit consultant should be required to keep all information acquired during the course of the audit confidential and to indemnify the landlord for any breach of this promise. Otherwise, the financial consequences of a small error can be immensely compounded if the other tenants get wind of the error. In addition, it is possible that the consultant will use its success to drum up more business by contacting the other tenants of the building or centre and advising them of the "error" it has discovered in the landlord's operating statement. Finally, the landlord will want to ensure that its operating cost information is not shared with its competitors. To strengthen the confidentiality requirement, the lease should require both the tenant and its audit consultant to sign a confidentiality agreement before they are permitted access to the landlord's financial records.

#### **6. Require that the audit be carried out with due diligence.**

**The Landlord's Perspective:** The lease should require the tenant to start its audit within a certain period of time – say, 14 to 21 days - after the date of its request, and that it carry out and complete its audit diligently and without delay. This prevents the tenant from requesting an audit and then leaving the landlord wondering for months as to whether the tenant is going to actually carry out the audit, and once started requires the tenant to either complete it within a reasonable period of time or abandon the audit.

**The Tenant's Perspective:** The tenant will need to ensure that the proposed time frame allows it adequate time to engage its audit consultant and complete the audit.

#### **7. Stipulate how the audit is to be conducted.**

**The Landlord's Perspective:** The lease should require that the audit take place only during the landlord's regular business hours. Otherwise, the landlord may be required to pay its employees overtime to oversee and reply to the tenant's audit consultant.

In addition, the audit should be carried out at the landlord's place of business or the location where the records are found. This will prevent the cost of transporting documents from one place to another, and prevent documents from being lost or misplaced.

**8. Stipulate that the audit right is forfeited upon default.**

**The Landlord's Perspective:** The lease should stipulate that the tenant's audit right is immediately forfeited if the tenant is ever in default and that any ongoing audits are to be immediately terminated.

**The Tenant's Perspective:** While it may be reasonable to expect that the tenant will not be permitted to exercise this right (or complete an ongoing audit) if it is in serious default of its lease, there are many ways that a tenant can be in technical, but not material, default of its lease, as for example a failure to obtain the landlord's consent before adding an extra electrical outlet in the premises. The tenant will wish to limit the kinds of default that will lead to the forfeiture of the tenant's audit right. It may also wish to provide that the right is not extinguished but is instead suspended until the default is cured. Finally, it will wish to provide that the audit right is neither extinguished nor suspended unless it has been given notice of the default and reasonable time to cure the same (remembering that most landlords will not give time to cure a rent default).

**9. Limit retroactive adjustments.**

**The Landlord's Perspective:** Ideally, the lease will include a drop dead date, as suggested above. In addition, the tenant's right to seek an adjustment to the operating cost statement should be limited to the current statement, and should exclude any retroactive adjustment affecting previous years, even if the tenant proves that an error was made. To this end, the tenant's access to the landlord's books and records should be limited to the year in question and should not extend to any previous year's financial records.

If the lease does not include this limitation, the audit of prior years can be restricted as follows:

**A. Same items only**

Allow the tenant to audit records from earlier years but only to the extent that they relate to the same item(s) that the tenant has overpaid.

Example: If the tenant finds that the landlord had overcharged for janitorial expenses in 2008, the tenant is not permitted to look at the landlord's previous years' records with respect to landscaping charges.

**B. Time limit**

Let the tenant audit only a certain number of earlier years – as for example, the two years immediately preceding the most recent operating cost statement.

Example: If the tenant found that its landlord had overcharged for janitorial expenses in 2008, the tenant can look back at janitorial expenses in the years 2007 and 2006, but not any earlier than that.

**10. Confirm that the tenant is responsible for the cost of its audit.**

**The Landlord's Perspective:** The lease should confirm that the tenant alone is responsible for the costs it incurs to carry out its audit. It should also require the tenant to reimburse the landlord for all costs that the landlord incurs in this regard. These costs may include photocopying, retrieving documents

from storage and providing personnel to oversee and carry out the landlord's involvement in the audit process.

**The Tenant's Perspective:** Larger tenants will often require the landlord to reimburse them their audit costs if the audit shows a discrepancy in the operating cost statement above a certain previously decided threshold. The landlord will wish to negotiate a threshold that is based on the amount payable to the tenant being in excess of an agreed percentage of all of the operating costs for the entire property, as this is a much more difficult threshold to meet. The tenant will want to have the percentage calculated on the categories of expenses in dispute or the tenant's share of operating expenses. The usual percentage is an overcharge in the range of 3 to 5%.

#### **11. Limit the length and number of audits.**

**The Landlord's Perspective:** The lease should limit how long an audit may last, particularly in light of the disruption that an audit may cause to the landlord's day-to-day operations. The typical lease provision will provide that the audit must be completed within a stipulated number of business days after it begins. It should also limit the number of audits that a tenant may conduct in any given fiscal or calendar year. If as suggested above, the lease stipulates a drop dead date, the tenant will for all practical purposes be limited to one audit per year.

**The Tenant's Perspective:** The tenant may be concerned that the one audit per year limit may preclude it from auditing statements issued by the landlord either in addition to or amending its year end statement of adjustments. A reasonable compromise may be to permit the tenant the right to conduct more than one audit per year, but to bar any re-examination of items that were previously audited or to limit the further audit right to items that the landlord has either added to or amended on its supplementary operating cost statements.

#### **12. Require a copy of the audit report.**

**The Landlord's Perspective:** The tenant should be compelled to give the landlord a true and complete copy of the audit report and supplementary materials immediately after the audit is completed. In this way, if the audit uncovers a problem, it can be quickly corrected. In order to ensure compliance with this requirement, the lease should provide that the tenant is deemed to have approved and accepted the landlord's additional rent or operating cost statement unless this section is complied with.

**The Tenant's Perspective:** While it is clear that the landlord will need to see the tenant's audit report before agreeing to reimburse (or credit) the tenant any overpayment disclosed by the audit, it may be that the audit reveals that the tenant was actually undercharged. In this case, the tenant may not want to be compelled to disclose its auditor's findings. The tenant may wish to provide that, instead of being required to provide a full and complete copy of the audit report, it agrees that it is deemed to have accepted the landlord's additional rent or operating cost statement save and except as shown to be incorrect by the tenant's audit report, but define the tenant's audit report as the report as disclosed to the landlord.

#### **13. Provide that neither subtenants nor assignees are to enjoy the same rights.**

**The Landlord's Perspective:** The landlord should try to ensure that the audit right is personal to the original tenant. This is particularly true with respect to subtenants as the landlord has no legal relationship with a subtenant.

**The Tenant's Perspective:** The tenant for whom audit rights in a lease are important is generally going to want to be able to pass these rights on to its assignees. By way of example, if the tenant is an anchor tenant, it will generally only assign its lease to another anchor tenant, who would in the ordinary course also require this right from its landlord. A reasonable compromise may be to agree to limit the assignee's audit right to the period arising on or after the date of the assignment of the lease; that is, agree that the assignee will not be permitted to audit for any period predating the assignee's interest in the premises.

#### **14. Credit any overpayment to the tenant's future rent instalments.**

**The Landlord's Perspective:** If the audit shows that the tenant has been overcharged, the landlord should try to have the lease provide that the amount found to be owing by the tenant be credited to the tenant's next rent payments rather than requiring the landlord to reimburse the tenant this amount in a lump sum payment. If possible, the landlord may wish to provide that the overpayment is to be "amortized" over the next 12 monthly instalments of rent, thus permitting the repayment to be carried out over a 12-month period.

**The Tenant's Perspective:** The overpayment has been created by the overcharging of the tenant over a 12-month period of time. Given landlords do not normally issue their operating cost adjustments until 3 or 4 months after the end of the fiscal or calendar year in question, the tenant has a strong argument that the repayment should be made immediately. A reasonable compromise may be to require that adjustments of less than one month's rent may be credited but any amount in excess of this must be repaid within 30 days.

#### **15. Settle disputes by referring to an agreed expert.**

Consider agreeing to use an expert to settle any dispute over the outcome of the audit. This will be quicker and less expensive than going to court or arbitrating the issue.

### **Good Faith and Honesty in Contract Performance: *Bhasin v. Hrynew***

This paper would not be complete without a discussion of the landmark decision on the duty of good faith in contractual performance. Until a few years ago, it was unclear whether the common law imposed on parties to a contract any legal obligation to act in good faith. In *Bhasin v. Hrynew*<sup>3</sup> ("*Bhasin*"), the Supreme Court of Canada articulated a new common law duty of honest performance that applies to all contracts. In the Court's view, the duty to act honestly aligns with the reasonable commercial expectations of parties to a contract.<sup>4</sup> The Court articulated two incremental steps in order to make the common law in relation to good faith performance of contracts less unsettled and piecemeal, more coherent and more just. The first step is to acknowledge that good faith contractual performance is a general organizing principle of the common law of contract. Good faith is not a free-standing rule, but rather a standard that underpins and is manifested in more specific legal doctrines and may be given different weight in different situations. The second is to recognize that, as a manifestation of this organizing principle of good faith, there is a common law duty which applies to all contracts to act honestly in the performance of contractual obligations.<sup>5</sup> While the precise content of

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<sup>3</sup> 2014 SCC 71.

<sup>4</sup> *Ibid.* at paras. 1, 62.

<sup>5</sup> *Ibid.* at para. 33.



honest performance will vary with context, parties are not permitted to contract out of the as yet undefined “minimum core requirements”.<sup>6</sup>

What are the potential implications in dealings between parties to a commercial lease?

Parties to all commercial contracts, including leases, are required to perform their respective contractual obligations honestly and reasonably.<sup>7</sup> While the landlord has the right to pursue its individual self-interest, it must not lie or knowingly mislead the tenant or act in a way that defeats the objectives of the lease.<sup>8</sup> Also, capricious or arbitrary behaviour is contrary to the duty to act honestly.<sup>9</sup>

What honesty and reasonableness in contract performance require will depend on the context, including the nature of the contract in question and the nature of the relationship between the parties.<sup>10</sup> A lease is more than a transactional exchange. It is a long-term relational contract that depends on mutual cooperation and trust between a landlord and tenant. As such, a court will likely require a high level of honesty and reasonableness in the performance of obligations under a lease, perhaps a higher level than for a one-time transactional exchange.

### **When the Lease is Silent on Tenant Audit Rights**

If a lease does not provide the tenant with an express right to request back-up information or to audit the landlord’s statement of additional rent or operating costs, it can be difficult for the tenant to verify the landlord’s charges. If the tenant requests back-up invoices, is the landlord required to provide such information to the tenant or can the landlord refuse to provide the information sought?

A landlord will not be able to use *Bhasin* to argue that, where the lease does not expressly include a tenant audit right, the landlord has no obligation to provide a proper statement and, if requested by the tenant, back-up material to support the charges. In my view, a landlord’s refusal to provide back-up information would be inconsistent with the general organizing principle of good faith and the duty of honest performance, especially since the records concerning the additional rent or operating costs are within the exclusive possession and control of the landlord.

This is precisely what the court concluded in *1877352 Ontario Inc. v. 699147 Ontario Inc.*<sup>11</sup> In this case, one of the issues considered by the court was whether the landlord was obliged to deliver documents that support its claim for additional rent. Referring to the *Bhasin* case, the court concluded as follows:

“The duty of the Landlord to honestly and reasonably perform its obligations under the Lease is served by requiring it to deliver all documents that are the basis for the annual adjustment: see *Bhasin v. Hrynew*, [...] at paras. 60, 63, 65, 93. In my view it is commercially reasonable to imply a term into the Lease that requires the Landlord to deliver with its annual adjustment for Additional Rent a copy of all the documents, such as tax bills, insurance premiums, property

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<sup>6</sup> *Ibid.* at para. 77.

<sup>7</sup> *Ibid.* at para. 63.

<sup>8</sup> *Ibid.* at para. 73.

<sup>9</sup> *Ibid.* at para. 63.

<sup>10</sup> *Ibid.* at paras. 60, 69.

<sup>11</sup> 2016 ONSC 445.

management invoices, which support and explain the amounts claimed from the Tenant in the adjustment.”<sup>12</sup>

There are other cases, albeit limited, that confirm that the tenant has a right to back-up information as a matter of sound business practice or an implied term of the lease.

In *Nguyen v. 792267 Ontario Ltd.*<sup>13</sup> (“*Nguyen*”), the landlord made demands for additional rent without providing particulars, which ultimately led to the wrongful termination of the lease by the landlord. Although the tenant had requested a proper accounting, the landlord did not comply. The court held that “[p]rinciple, and indeed precedent (though sparse), clearly demonstrate that a landlord, having ownership and control of the premises and knowledge of the expenses associated therewith, has the obligation to provide the tenant with a proper statement and if required, back up material to support a claim for “additional rent” ”<sup>14</sup> In the courts view, the landlord’s actions demonstrated an unwillingness to act in a business-like manner.

The obligation to provide back-up material, as expressed in *Nguyen*, is consistent with the line of reasoning in *663579 Ontario Ltd. v. First Choice Haircutters Limited*<sup>15</sup> (“*First Choice Haircutters*”). In response to the tenant’s dispute of some of the items charged by the landlord, the Court required the landlord to establish that the expenditures were reasonable, *actually incurred* and fell under the definition of operating costs in the lease. The Court held as follows:

“I am of the opinion that the tenant is entitled to examine invoices, bills, and vouchers claimed by the landlord as being operating expenses in order for the tenant to verify their correctness as being operating costs under the lease.

The landlord has a clear responsibility to afford the tenant a reasonable opportunity, if requested by the tenant, of examining these invoices, bills and vouchers claimed as operating expenses. The landlord does not meet that responsibility under the terms of the lease by simply making its books available to the tenant.”<sup>16</sup>

In *Loyaltyone Inc. v. Cadillac Fairview Corporation Limited*<sup>17</sup> The tenant sought an order requiring the landlord to provide the tenant with all back-up information pertaining to the landlord’s calculation of operating costs, including invoices, bills, calculations, allocations or similar documentation to demonstrate that the expenses claimed by the landlord were reasonable and actually incurred. The landlord brought a motion to strike a paragraph in the tenant’s claim for failure to disclose a reasonable cause of action. The landlord’s motion was dismissed because it was not “plain, obvious and beyond doubt”<sup>18</sup> that the tenant’s claim for access to supporting documentation could not as a matter of law or equity succeed. The Court agreed with the tenant that the *First Choice Haircutters* case offered support to the tenant’s position that a landlord “can be obliged, whether as a matter of contract or good faith and fair dealing, to produce the documentation sought”.<sup>19</sup>

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<sup>12</sup> *Ibid.* at para. 30.

<sup>13</sup> 2006 CarswellOnt 7595 (Ont. S.C.J.).

<sup>14</sup> *Ibid.* at para. 14.

<sup>15</sup> [1994] O.J. No. 1122.

<sup>16</sup> *Ibid.* at paras. 37 and 38.

<sup>17</sup> 2009 CanLII 19935 (ON SC).

<sup>18</sup> *Ibid.* at para. 5.

<sup>19</sup> *Ibid.* at para. 4.

Case law from other common law jurisdictions has arrived at a similar conclusion. In response to a tenant's request for supporting invoices in the 1991 case *Village Markets Ltd. v. First Commercial Managements and Penstar Properties Inc.*<sup>20</sup>, the Supreme Court of British Columbia held that, although the landlord did not have the obligation to make the invoices available for inspection, as a matter of sound business practice the landlord should have done so. This would give the tenants an opportunity to examine and consider the invoices for charges they are expected to assume. It would also give them an indication of the exact nature of the work being charged for and an opportunity to determine whether the work charged for was actually done. The court did not see why the tenants should have to accept at face value the auditor's certification that all the charges were properly set out and charged appropriately.

In the American case *P.V. Properties, Inc. v. Rock Creek Village Associates Limited Partnership*<sup>21</sup>, the Court of Special Appeals of Maryland was called upon to decide whether a shopping center tenant was entitled to an itemized list of common area maintenance expenses where the lease was silent on that issue and the landlord refused to provide an itemized bill. The lease required the landlord to provide the tenant with a yearly written statement setting forth the "total actual costs" incurred by the landlord in operating and maintaining the common areas and charged to the tenant. The Court decided in favour of the tenant and held that the landlord was required to provide to the tenant an annual statement outlining in detail the type and amount of each expense it incurred. According to the Court, the requirement to itemize in detail the various expenses incurred could also be implied from the terms of the lease. The Court went on to say:

"The obligation of good faith and cooperation implied in every contract gives rise to the implied requirement on the part of the landlord to disclose its cost data and the basis upon which the tenant's common area maintenance liability was computed.

[...]

Reason and fairness require that the tenant be afforded some means of verifying the charges assessed against it. Otherwise, the tenant has no way of determining whether the charges it is being forced to pay fall within the scope of its obligations under the lease. The parties are under a duty to act in good faith and deal fairly with each other.<sup>22</sup>

What is abundantly clear from a review of the above-noted case law is that a landlord has a positive duty to provide back-up material to a tenant to support a claim for additional rent or operating costs. As one writer cautions, "a lease that does not specifically address the tenant's right to audit leaves the door open to a lease audit through implied rules applicable to good faith and fair dealing. From a tenant's perspective, however, silence has no bearing on how an audit will be performed. [...] Including a proper lease audit clause in the lease can act as the best line of defence against future audits."<sup>23</sup> Both tenant and landlord would do well to negotiate the parameters of the tenant's audit rights.

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<sup>20</sup> No. C901965 Vancouver Registry, 1991 (S.C. of B.C.).

<sup>21</sup> 77 Md. App. 77(1988) (Maryland Court of Special Appeals).

<sup>22</sup> *Ibid.* at p. 5.

<sup>23</sup> Paul Mayer, "Lease Audits", 2005 eSpace Montreal Vol. 15, No. 2, *supra* on p. 6.

## Conclusion

While landlords will fight tooth and nail to avoid granting audit rights to tenants (because of the nuisance, cost and confidentiality issues associated with lease audits), tenants with sufficient bargaining power will insist on having audit rights included in their leases. That said, a tenant is not barred from requesting an audit where the lease is silent and the tenant may be more prone to perform an unreasonable or overzealous audit if there are no limits imposed on it. As such, it may be preferable for the landlord to address its concerns head-on by negotiating an audit right that is subject to strict limitations as to scope, confidentiality and number of years that may be audited. In fact, a well-crafted lease audit provision may alleviate some of the landlord's risks and concerns. The challenge is to strike an appropriate balance between the competing interests of the landlord and tenant.

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The comments contained in this article provide general information only. They should not be regarded or relied upon as legal advice or opinions. Gowling WLG (Canada) LLP would be pleased to provide more information or specific advice on matters of interest to the reader.