



Defending Liberty
Pursuing Justice

Committee Cochairs

Vernon F. Dunbar
Turner Padgett
Greeneville, SC
(864) 552-4601
vdunbar@turnerpadgett.com

Bart L. Greenwald
Frost Brown Todd LLC
Louisville, KY
(502) 568-0318
bgreenwald@fbtlaw.com

Doug McCoy
Hand Arendall LLC
Mobile, AL
(251) 694-6255
dmccoy@handarendall.com

Journal Editors

Amy G. Doehring
McDermott Will & Emery LLP
Chicago, IL
(312) 984-7639
adoehring@mwe.com

Thomas A. Dye
Carlton Fields
West Palm Beach, FL
(561) 650-0337
tadye@carltonfields.com

Stuart J. Glick
Sills Cummis & Gross PC
Newark, NJ
(973) 643-6937
sglick@sillscummis.com

ABA Publishing

Jeff Salyards
Associate Editor
Sonya Taylor
Designer

Business Torts Journal is published quarterly by the Committee on Business Torts Litigation, Section of Litigation, American Bar Association, 321 N. Clark Street, Chicago, IL 60654-7598. The views expressed within do not necessarily reflect the views of the American Bar Association, the Section of Litigation, or the Committee on Business Torts Litigation.
© 2008 American Bar Association

www.abanet.org/litigation/committees/business_torts

SECTION of LITIGATION
AMERICAN BAR ASSOCIATION

Business Torts Journal

Fraud Issue

VOL. 16 NUMBER 1 ■ FALL 2008



The Facts of Fraud

By Scott P. Hilsen

Regardless of the company's size, an average company loses an estimated 7 percent of its annual revenues to occupational fraud on a dollar-for-dollar basis. That is the result of a study by the Association of Certified Fraud Examiners (ACFE) based on 959 reported fraud cases between January 2006 and February 2008.¹ The amounts lost may be material depending upon the circumstances, and certainly are at levels that would interest management. Occupational fraud, however, does not lend itself to being readily predictable or quantifiable, so it rarely is measured at the organizational level. Viewing occupational fraud from a macro level, some degree of it exists in virtually every industry and in virtually every kind of organization, whether for profit, publicly owned, or governmental.² Being proactive about finding and preventing fraud, therefore, not only can have a direct impact on the bottom line, it demonstrates fiduciary responsibility.

The Delaware Supreme Court recently affirmed a corporate director's responsibilities in a case alleging that directors failed to prevent misconduct by employees, which resulted in \$50 million in fines and penalties. In *Stone v. Ritter*,³ the court held that directors can be liable in their oversight capacity when corporate employees engage in misconduct if there is a showing of bad faith. Under the affirmed *Caremark* standard, liability does not attach if directors implement a system of reporting and controls and if they monitor the system to ensure that they are being informed of risks or problems.⁴ In *Stone*, the company had created and monitored a program to prevent money laundering violations and, thus, the allegations against the directors were insufficient to show bad faith. An effective fraud prevention program, therefore, is an important tool to show good faith in combating fraud and misconduct.

To prevent occupational fraud, it first is important to understand the scope, who is engaging in it, and why they are doing it. Occupational fraud broadly means an employee's intentional misuse of the organization's resources or assets. The three primary categories are financial statement fraud, corruption and conflict of interest, and asset misappropriation. Examples of various misconduct include accounting and financial fraud, bribery and other corrupt influence practices, and payroll and billing schemes. Whatever the flavor, the misconduct involves intentional acts for the employee's benefit at the expense of the company.

(Continued on page 18)

Inside This Issue

Message from the Chairs	2
Message from the Editors	3
Private Rights of Action under the Investment Company Act of 1940.....	4
Maximizing D&O Insurance for Subprime and Options Backdating Claims.....	8
Hey, What's the Big Idea? Pretrial Attacks on Fraud Claims in the Idea Submission Context	11
Fraudulent Common Area Overcharges in Commercial Leases	16



Fraudulent Common Area Overcharges in Commercial Leases

By Zachary D. Schorr

What does a commercial tenant do when it believes it is being fraudulently overcharged for the common area expense that it agreed to pay in its lease? A tenant's ability to prove its claim for fraudulent overcharges may rest on whether it has a right to an accounting or an audit. Without such a right, the tenant has limited options for proving the fraud because the tenant simply is not privy to the actual charges the landlord has incurred and passed on to it. The tenant can sue for fraud or for an accounting, and for breach of contract, but before doing so, it should consider the likelihood of whether the lease or the applicable law of the jurisdiction gives the tenant a right to an accounting or to conduct an audit.

In today's commercial real estate market, which is quickly beginning to resemble the struggling residential real estate market, commercial property owners and landlords are always seeking ways to reduce their operating expenses. The typical triple-net lease provides that all expenses, including maintenance, property taxes, and insurance (collectively, CAM), be passed through to the tenant, and the tenant will be required to pay its proportionate share based on the size of the area the tenant has leased. In other words, the commercial lease terms will generally provide that the tenant pay the percentage of total CAM charges that its leased square footage bears to the total leasable square footage of the entire commercial property. Thus, the expense of maintaining and operating the commercial property is passed through to the tenant.

The common dispute over the validity of CAM charges arises from the fact that the tenant is generally not privy to the actual CAM charges that the landlord has incurred on its behalf. Instead, the tenant must rely on the landlord's representations. This can lead to misrepresentations regarding the charges that the tenants are forced to rely on and pay. The issue then becomes whether the tenant suspecting CAM overcharges and fraud has a right to verify the landlord's charges. When fraud is suspected and the tenant seeks to prove the overcharges or to allege its fraud claim with the required specificity, the focus becomes whether the tenant has a right to an accounting or audit by virtue of the terms of the lease or the applicable law, and/or whether the CAM charges have been paid in advance.

When Audit Rights Are Not Provided by the Lease: The Covenant of Good Faith and Fair Dealing

Many commercial leases are silent on the issue of a tenant's right to audit the CAM charges or to perform an accounting. Some

leases permit the tenant to get a statement of charges but not to investigate further. This may not satisfy the suspicions of a tenant who has reason to believe that the summary of charges provided by the landlord do not reflect the actual expenses incurred.

In California, one of the leading cases to discuss audit rights is *McClain v. Octagon Plaza, LLC*.¹ In *McClain*, the tenant entered into a standard American Industrial Real Estate Association Form lease in February 2003 for commercial space in a shopping center located in Valencia, California. As part of the terms of her lease, she agreed to pay, as additional rent, 23 percent of the "Common Area Operating Expenses," which the lease defined as costs incurred by Octagon for enumerated purposes "relating to the ownership and operation" of the shopping center. The lease further provided that McClain's share of the common expenses was due no later than 10 days after Octagon provided her with a "reasonably detailed statement of actual expenses."² The lease also provided Octagon with the option to estimate its common area expenses for the upcoming calendar year and to require McClain to pay a prorated share of the estimate with her monthly base rent during the year. If Octagon selected this option, then it was required to provide a "reasonably detailed statement" showing her actual annual common expenses within 60 days after the end of the calendar year.³

In 2005, McClain filed an action alleging an intentional and negligent misrepresentation of the size of her leased unit (causing her percentage of CAM charges to increase) and for an accounting on the CAM charges. Following a bench trial, the court found that McClain had no right to an accounting under the lease, and judgment was entered against her. On appeal, McClain contended that the trial court erred in denying her request for a declaration that she is entitled to an accounting of her share of the CAM charges.⁴ She argued that the express provisions of the lease, along with the implied covenant of good faith and fair dealing contained in all contracts, oblige Octagon to permit her to examine its records to verify her share of the common area expenses.

The record showed that when McClain requested a "reasonably detailed statement" of the common area expenses as well as permission for an auditor to examine Octagon's records, Octagon agreed to provide a more detailed statement but refused to allow the auditor to examine its records. On appeal, McClain argued that the implied covenant of good faith and fair dealing supported her request for the right to audit Octagon's records. In so doing,

McClain attempted to rely on a line of cases that grant parties a right to an accounting in situations where two parties enter into an agreement for the sharing of profits, where one party has exclusive access and control over the financial records.⁵

The court held that McClain was not entitled to dispute the need for expenses or to audit Octagon's records.⁶ The court found that "because McClain's share of the common area expenses under the lease is determined by the *actual expenses* incurred by Octagon, she is entitled to verify that such expenses were, in fact, incurred and that the listed amounts are accurate."⁷ Octagon, however, was permitted to discharge this obligation in any reasonable manner it selected. Thus, California did not permit McClain to obtain an accounting by virtue of the implied covenant of good faith and fair dealing.

The Right to an Accounting via Prepayment of Common Area Expense Charges

In certain jurisdictions, tenants can gain accounting rights even when they are not expressly provided by the lease, by showing that a fiduciary relationship exist between the landlord and tenant. For example, in *Best Buy Stores, L.P. v. Developers Diversified Realty Corporation*,⁸ Best Buy commenced an action alleging that the defendant 16 landlords had failed to accurately calculate the common area expenses and costs charged to Best Buy in 13 different states. Best Buy alleged that its entrustment of the advance payments to defendants (for common area expenses), pursuant to its lease obligations, created a fiduciary duty. In other words, the landlord became a fiduciary because it has access and control over the tenant's prepaid common area expense charges.

The court of appeals, in ruling on the demurrers of the defendants, determined that the existence of a fiduciary relationship is a question of state law. As a result, the court turned its analysis to whether certain states recognize the possibility of a fiduciary relationship arising out of a landlord-tenant relationship. Without the underlying fiduciary relationship created by the prepayment of common area expenses, the court did not have the ability to order an accounting, absent an express provision in the lease providing for such a right.⁹

In Arizona, a fiduciary relationship has been shown to exist in the landlord-tenant context in *Divizio v. Kewin Enterprises*.¹⁰ In *Divizio*, the Arizona Court of Appeals recognized a limited fiduciary relationship between individual lot owners and common area owners, arising out of the covenants requiring the lot owners to pay a monthly fee for common area maintenance costs. The court found that a fiduciary relationship existed between the parties that required the operators to furnish accountings of the common area maintenance fees.¹¹

Likewise, the Colorado Supreme Court has long recognized that landlords and tenants are included "in the class of persons between whom the relation is of a fiduciary nature, so as to require the utmost degree of good faith in all transactions between them."¹²

Arizona and Colorado are just two of the states that recognize the possibility of a fiduciary duty arising out of the landlord-tenant

relationship. This fiduciary duty, in turn, can open the door to accounting and audit rights by a tenant that has reason to believe that it has overpaid its common area expenses.

Common Area Overcharge as Fraud Regardless of the Lease

If the commercial tenant discovers the overcharge, the tenant must then determine whether it has a viable claim for fraud or simply breach of contract. While some jurisdictions take an expansive view of possible fiduciary duties between a landlord and a tenant to permit the tenant to obtain an accounting for common area expenses, the same may not hold true for the tenant's ability to allege both a fraud and a breach of contract claim. This issue was also addressed in *Best Buy*; all parties agreed with the general rule that a breach of contract by itself is not an actionable tort. To be actionable, the breach must accompany the violation of an independent duty imposed by law.

Arizona and Colorado are just two
of the states that recognize the
possibility of a fiduciary duty arising
out of the landlord-tenant relationship.

However, in some states, such as Minnesota, the courts have determined that exceptional circumstances must exist for a party to be able to recover tort damages for a breach of contract, and that "a relationship would exist which would give rise to the legal duty without enforcement of the contract promise itself."¹³

In other states, such as Arizona, intentional fraud is based on a duty independent of those imposed by contract; therefore, an independent duty not to commit fraud exists regardless of the breach of contract claim.¹⁴ In Arizona, Best Buy could maintain a cause of action for both fraud and breach of contract based on the landlord's alleged misrepresentations of the common area expenses.

Ultimately, in *Best Buy*, the court came to different conclusions on whether Best Buy could maintain an action for fraud separate from the commercial tenant's breach of contract cause of action—depending under the laws of the underlying states. The viability of Best Buy's claim rested largely on whether the court recognized an independent duty not to commit intentional fraud.

The Double-Edged Landlord-Tenant Relationship

In summary, the landlord-tenant relationship has significant impact on the ability of a tenant to conduct an audit/accounting and then to sue for fraud in the event it determines the landlord to be overcharging its proportionate share of the common area expenses.

Depending on the jurisdiction, the landlord-tenant relationship can either bolster the ability to conduct an accounting through an express provision in the lease or through the existence of a fiduciary duty created by virtue of the fact that the tenant has entrusted the landlord with advance payments on its share of the common area expenses. Alternatively, the existence of the landlord-tenant relationship and the formality of signing a lease can, in certain jurisdictions, prohibit the tenant from suing for fraud due to the mutually exclusive existence of the breach of contract remedy.

The solution is to plan for this all too common dispute through providing an express mechanism in the commercial lease for audit and accounting rights. ■

Zachary D. Schorr is the lead real estate attorney at Schorr Law, A Professional Corporation, Los Angeles, California.

Endnotes

1. *McLain v. Octagon Plaza*, 159 Cal. App. 4th 784 (2d Dist. 2003).

2. *Id.* at 790.

3. *Id.*

4. *Id.* at 805.

5. *Id.* at 806.

6. *Id.* at 805.

7. *Id.* at 808.

8. *Best Buy Stores, L.P. v. Developers Diversified Realty Corp.*, No. 05-2310, 2006 U.S. Dist. LEXIS 89182 (D. Minn. Dec. 8, 2006).

9. *Divizio v. Kewin Enters.*, 666 P.2d 1085 (Ariz. App. Ct. 1983).

10. *Id.*

11. *Best Buy*, 2006 U.S. Dist. LEXIS 89182 at *27 (citing *Divizio*, 666 P.2d at 1086-88).

12. *Id.* at 28 (citing *Hurt v. Schneider*, 156 P. 600, 602 (Colo. 1916)).

13. *Hanks v. Hubbard Broad., Inc.*, 493 N.W.2d 302, 308 (Minn. Ct. App. 1992).

14. *KD & KD Enters., LLC v. Touch Automatio, LLC*, No. CV-06-2083-PHX-FJM, 2006 U.S. Dist. LEXIS 93730, at *4-*7 (D. Ariz. Dec. 27, 2006).

THE FACTS OF FRAUD

(Continued from page 1)

The ACFE found that nearly 40 percent of the individuals committing fraud were at the managerial level and that there was no tangible difference between the number of male versus female perpetrators.⁵ Almost a third of the frauds were committed in the accounting department, with 18 percent in executive/upper management, and 11 percent in sales.⁶ Virtually none of the individuals had criminal records, and nearly a third of them colluded with another person.⁷ Interestingly, the dollar loss associated with fraud was found to be directly proportional to a person's annual income, age, education, and tenure.⁸

Why are these individuals committing fraud? Many theories exist, but one of the most accepted is that of Dr. Donald Cressey who devised the "fraud triangle." The fraud triangle graphically represents the three elements that must exist for fraud to occur—pressure, opportunity, and rationalization.⁹ Individuals committing fraud are in positions that give them opportunity and that come hand-in-hand with pressures to perform. The rationalization oftentimes is the result of these pressures, and a difficult work environment is a common reason fraud is committed.¹⁰ Pressures outside the workplace have been found to lead to a disproportionately large amount of fraud. The obvious ones are marital problems, substance abuse, and gambling problems, which frequently are apparent to others. But there are some that are more subtle. The desire to obtain a level of financial or social status, for instance, has been found to be a strong rationalization for some people to commit fraud and oftentimes it is not noticeable.¹¹

There are some signs, however, that could signal a potential problem. In one study, the most common characteristics shared by those committing fraud were living beyond a person's means,

high personal debt, an overwhelming desire for personal gain, and a feeling that pay was not commensurate with responsibility.¹² These may be manifested as unusual purchases of luxury items and property, or uncharacteristic complaints about the person's job or income, the company's stock price, or the market in general. More often than not, though, fraud is not readily detectable.

A lot of time and money has been devoted to detecting occupational fraud. Audits of public companies must involve reasonable procedures designed to detect fraud,¹³ and internal audit departments are becoming commonplace in certain industries. By far, however, the most common manner in which a fraud is discovered is by a tip. In 46 percent of the cases studied by the ACFE, a tip from an employee, a customer, or a vender was the reason a fraud was detected.¹⁴ It is no solace to those paying fees to outside auditors to learn that external audits were only the fifth most effective way to detect fraud, following internal audit and internal controls.¹⁵ More disconcerting is that the second most common reason fraud is discovered is by sheer accident, accounting for over 20 percent.¹⁶ Difficulties in detecting fraud highlight why it is vital that a company also focus on prevention.

The widely accepted view among fraud prevention professionals is that the most effective fraud prevention method is to create the perception of being detected.¹⁷ A person is less likely to commit a fraud if he or she thinks that it will be detected, regardless of the punishment, because the risk of being exposed poses the greatest threat.¹⁸ This may explain why white collar criminals frequently suffer a great deal more from the loss of respect and injury to their reputation than from sanctions or imprisonment. Effective controls, of course, must be in place to try to detect fraud, but creating the