



Operating Expense Clauses in Commercial Leases: The Capital Expenses Exclusion

(First in a Series)

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Many commercial leases contain provisions requiring the tenant to pay, in addition to the fixed rent, amounts to reimburse the landlord for the tenant’s share of the costs and expenses of operating and maintaining the property. Such provisions may be known by various names, such as Operating Expenses, Common Area Maintenance Charges, etc. The provisions describe the nature of the operating expenses that landlords can pass through to tenants, but invariably they will have a “catch-all”, so a tenant cannot be certain of the universe of operating expenses that a landlord may attempt to impose upon the tenant.

Tenants’ attorneys combat this uncertainty by listing categories of operating expenses which are to be excluded and may not be passed through to the tenant. This list of exclusions is the “guts” of the provision and where a significant amount of negotiation will occur. An experienced real estate lawyer will have developed a list of operating expense exclusions to present to landlord’s counsel. **Our list is now about five (5) pages long.**

The examples below are of some exclusions that, if not properly negotiated by a tenant’s attorney, can be costly to the tenant’s bottom-line and impact the “value” of their lease.

- The principal of the landlord is married to an artist. The landlord entity purchased from the principal’s spouse (for a considerable sum) a piece of artwork for prominent display in the building’s lobby. It may or may not have been a beautiful piece, but the pertinent fact is that the landlord included the cost of the artwork in that year’s operating expenses. In effect, the tenants bought the artwork for the building from the principal’s spouse without getting any ownership interest. The solution is to exclude from operating expenses **any costs for sculpture, paintings or other objects of art (including any maintenance thereof and/or outside contracting therefor).**
- Landlord’s principal had more than one business. One such business was a company that provided cleaning services to commercial buildings. Unsurprisingly, this cleaning company provides cleaning services to the building. As the principal of each company is on both sides of the negotiating table, it should not come as a shock that the price for the cleaning services provided is not what would be expected in a typical arms-length transaction. The extra cost, of course, is passed through to the building’s tenants as operating expenses. The solution is to exclude from operating expenses **any amounts paid to affiliates of landlord for goods supplied to the building or for services provided in or to the building, to the extent the same would exceed the costs of such goods sold or services rendered by third parties that are not affiliates of landlord.**

- As a terrific amenity, the building has a parking garage for which each user pays a separate monthly fee. Since the purpose of the parking fees is to cover the garage's expenses, the landlord is collecting the same expenses twice if the operating expenses of the parking garage are included in operating expenses covered by tenants. For example, if it costs \$20 to park for the day in your building and that \$20 is used to cover the garage's operating expenses, but the building's operating expenses that are covered by tenants also include the costs and expenses of running the garage, the landlord gets a windfall. The solution is to exclude from operating expenses **any costs incurred by landlord in connection with the operation, maintenance, repair, replacement, or third party management of the building's garage, including any equipment used in connection with the operation thereof, if there is a separate fee collected for parking in the garage (this concept gets complicated when the landlord is partially subsidizing the cost of the parking in the parking garage because now a determination needs to be made as to what is the "market rate" because it is appropriate for the landlord to be reimbursed for a certain amount of the "discounted" parking, but that discussion is beyond the scope of this note). More broadly, tenants should also consider excluding from operating expenses the costs of operating or maintaining any specialty services or amenities for which users pay a separate fee (e.g., fitness center) under the theory that the landlord is collecting money twice for the same services.**
- The building is damaged by a casualty. Landlord promptly repairs the damage and the tenants are back in their spaces and running their businesses within a short time. The costs of the repair are passed through to tenants as an operating expense. However, the landlord also collected from its casualty insurance company for the cost of the repairs, thereby "double-dipping". The solution is to exclude from operating expenses: **any costs reimbursed by insurance or would have been reimbursed by insurance had landlord maintained the insurance required by the lease to be maintained by landlord (a refinement is to exclude any costs reimbursable by insurance, thereby putting the risk of collection on landlord and not on the tenants).**

In subsequent notes we will discuss other aspects of the typical operating expenses clause in a lease that can save tenants time and money.

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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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