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THE WIRE

Operating Expense Clauses in Commercial Leases: The Capital Expenses Exclusion

(Second in a Series)

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Our last note (which may be accessed here) highlighted the importance of effectively negotiating exclusions to Operating Expenses and offered examples of some exclusions that, if not properly negotiated, can significantly impact the tenant's bottom line.

This note focuses on another important exclusion from its lease that every tenant must aggressively negotiate to obtain, in some form. **This important exclusion is the Capital Expenses exclusion.** It is fair to say that of all the exclusions to Operating Expenses, this is the single most important one because it is the one with the most money at stake.

If you are leasing office space in a building, what costs would you expect to pay for?

- Landlord's cost for adding additional floors to the building – **that is absurd**
- Landlord's cost for renovating the building's common lobby – **no**
- Landlord's cost for upgrading building systems to make the building more energy efficient (e.g., smart elevators. LEED certification) – **not really**
- Landlord's cost for replacing the elevator cables – **well, maybe**

Each of the above are examples of costs that can be capitalized. (Interestingly, many leases will not define the word "capital," leaving the determination to Landlord's discretion. We suggest that tenants insist that the landlord pick some standard such as GAAP or the Internal Revenue Code.) But, it is clear that not all capital costs are equal.

In our experience, a successful negotiation of the Capital Expenses exclusion should result in the inclusion of only the following **two** types of capital improvements/items:

> (x) any capital improvement, the installation of which commenced after the commencement date of the tenant's lease, which improvement was intended to reduce Operating Expenses, and, in such case, only to the extent of the actual reduction that the landlord demonstrates to the tenant (By way of example: Suppose the annual cost of maintenance and repairs associated with the elevator cables is $100,000. If it costs the landlord $500,000 to install new elevator cables but the annual maintenance and repair costs associated with such new elevator cables are still $100,000, then the landlord would not be able to pass through to the tenant the cost of such new elevator cables because there are no actual savings in Operating Expenses that resulted from replacing the elevator cables. However, if it costs the landlord $500,000 to install

new elevator cables, and the annual maintenance and repair costs associated with such elevator cables is now $75,000, then landlord would be able to pass through to the tenant such tenant's proportionate share of the cost of the new elevator cables to the extent of the actual annual savings, until either the cost of the new cables has been recovered or the useful life of the new cables has ended, whichever is earlier.), or

(y) any capital improvement, the installation of which is required to comply with any laws first enacted after the commencement date of the tenant's lease.

The costs of (x) and (y) above would be amortized over the "useful life" of the improvements together with interest on the unamortized amount. Here, again, most leases do not define the standard for determining the appropriate length of the useful life. We suggest that tenants insist on either the longest useful life as defined in the Internal Revenue Code or the longest useful life based on the current Marshall & Swift publication. Tenants should also negotiate the amount of the interest rate.

In extremely rare circumstances, a tenant might persuade the landlord to agree to a monetary cap or agree that only costs that have been pre-approved by the tenant can be passed through. In rarer circumstances still (like endangered species rare), a tenant might be able to completely exclude capital expenses from Operating Expenses.

If a tenant overlooks the importance of negotiating the Capital Expenses exclusion, it will be on the hook for costs that may dramatically impact the tenant's bottom line and the value of its lease.

In the next note we will discuss the importance of having a provision in the lease which entitles the tenant to review landlord's books and records with respect to operating expenses—**the goal being to keep the landlord honest!**

Shane O'Neill joined the firm as an associate upon its founding and became a partner in 1995. Shane graduated from Haverford College in 1983 and Fordham University School of Law in 1986. After graduation from law school, he joined Shea & Gould as an associate, and remained there until the formation of Ingram Yuzek. He is admitted to the New York State Bar and is a member of the Association of the Bar of the City of New York, the New York State Bar Association, and the American Bar Association.

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.

Amol Pachnanda joined the firm in 2005 and became a partner in 2012. Amol has broad experience in advising clients in all aspects of real estate law across the United States, including office and retail leasing (representing both landlords and tenants), purchase & sales (both residential and commercial), and mortgage financing. Amol also negotiates commercial leases for U.S. based clients operating in India (Note: No foreign law firm, including Ingram Yuzek Gainen Carroll & Bertolotti LLP, is authorized to practice law in India).