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Capital Expenditures in an Office Lease: Who's on the Hook?

The overwhelming majority of offices leases allow the landlord to recover, in addition to its base rent, all or a portion of the landlord's expenses of owning and operating an office building. The lease provisions that govern these "pass-throughs" of operating expenses from landlords to tenants have the dubious distinction of being the most negotiated (and over-negotiated) provisions of the lease.

Office landlords typically prepare the initial lease draft. Because the specifics of operating expense pass-throughs are rarely included in the Letter of Intent, the landlord's initial draft sets the tone for negotiations. The description of recoverable operating expenses will usually begin with broad language such as: "all costs, charges, impositions and expenses incurred by the landlord in connection with the ownership, operation, management, maintenance, repair and replacement of the building." This language is then followed by a list of specific expenses that are expressly *included* within operating expenses, which is in turn followed by a list of specific *exclusions* from operating expenses. As lease negotiations progress, the lawyers perform a well-established ritual whereby landlord's counsel tries to defend its lists while tenant's counsel tries to eliminate the inclusions and add to the exclusions. Much of this is relatively uncontroversial and amounts to little more than a game between lawyers. However, some expenses are quite substantial and whether they end up included or excluded from pass-throughs can significantly impact a tenant's leasing costs. Among such expenses are capital expenditures.

As a general rule, tenants should not pay for a landlord's capital expenditures (i.e., costs of items considered capital repairs,

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replacements, improvements or equipment under generally accepted accounting principles). These expenditures, by definition, extend beyond the current year and increase the long-term value of the landlord's building. They are not normal operating costs and should be factored into the base rent instead of being recouped as a pass-through. A tenant should always insist on a general exclusion for capital expenditures with concessions for two well-recognized exceptions to this rule:

■ **Exception 1: Capital Expenditures to Comply with New Laws.** Landlords are consistently successful in negotiating pass-throughs of capital expenditures for items that are necessary to comply with new laws (or changes to existing laws) that are enacted after the date the lease is signed. Relatively recent examples include the Americans with Disabilities Act laws and laws requiring new fire sprinklers. The costs of complying with these laws can be incredibly high, and because these costs are difficult (or impossible) to foresee, they cannot be factored into the base rent. Therefore, landlords insist on recouping these costs. A tenant may argue, quite convincingly, that there is no logical reason for these costs to be passed through and these are merely part of the landlord's cost of doing business. But the simple fact is that these costs are almost always passed through. For the tenant, it's not a battle worth fighting.

■ **Exception 2: Capital Improvements that Reduce Operating Expenses.** This exception is somewhat intuitive. Office leases should provide that landlords can pass through the costs of capital improvements that actually result in cost savings for the tenant. For example, consider a situation where a landlord has the opportunity to perform an energy retrofit to its building that will dramatically reduce energy costs. The landlord would like to see its building improved and the tenants would like to see their operating expenses reduced. But if the landlord is not able to recoup its costs for the capital improvements, the landlord will have little incentive to perform the work and the potential cost savings may go unrealized. By passing through these costs, both parties can receive benefits from cost-saving improvements. For the tenant, it is important that the amount of pass-throughs be no greater than the amount of the *actual* cost savings. This ensures that a tenant's operating expenses are reduced or, at a minimum, are not increased by virtue of the capital improvement. Landlords, on the other hand, should resist this limitation and push for pass-throughs capped at the reasonably *anticipated* cost savings. The outcome on this point determines who bears the risk of an underperforming capital improvement. Finally, it is important to note that this exception should apply only to capital improvements that reduce operating expenses by increasing efficiency. It should not operate as a back door for landlords to pass through capital *repairs* and/or *replacements*. For example, replacing an outdated, leaky roof will surely reduce operating expenses (by eliminating ongoing repairs) but that is not something for which a tenant should have any responsibility.

In addition to these well-recognized exceptions, many landlords have successfully negotiated pass-throughs of capital expenditures that increase building security or access, reduce the building's carbon footprint or provide other intangible benefits to tenants and tenants' employees. Many landlords will also seek the pass-through of minor capital expenditures (e.g., less than $3,000 per item or $10,000 in the annual aggregate) in an attempt to keep administrative costs down.

As a final note, in each instance where capital expenditures are passed through to the tenant, the lease must clearly describe the amortization period. Typically the landlord's costs are amortized over the useful life of the expenditure, but for cost-saving improvements, the landlord may seek to shorten this period to make the improvement economically feasible.

Hopefully these discussion points can help office landlords and tenants avoid some of the all-too-common gamesmanship and quickly reach agreement on an evenly balanced provision with respect to capital expenditure pass-throughs.