

Major Capital Expenditures Pass Through

Landlords and tenants of commercial office buildings have had a long and tenuous 2 years with stops and false starts as tenants have struggled to engage their staff return to the office. With the increasing adoption of hybrid work models, there is further pressure on landlords to retain tenants by way of new amenities and facilities such as conference rooms and gyms, to name a few. We want to explore how the cost of such programs or projects can affect the operating expenses incurred by tenants in commercial offices.

Examples:

An office building is doing an HVAC retrofit to help reduce the spread of COVID. A project of this nature would be considered a Capital Expense. Illustrated below are three hypothetical tenants with different leases - let's examine the respective expense impact.

#1 – Low Risk Lease	#2 – Medium Risk Lease	#3 – High Risk Lease
Lease does not allow Capital Expenditures.	Allows for Capital Expenditures that reduce OPEX	Allows for all Capital Expenditures, Improvements & Replacements
Lease language often to the effect that the tenant is responsible for ongoing HVAC repairs and maintenance; however, all capital expenditures are excluded. This limitation on the inclusion of capital expenditures is often stated in an <u>Exclusion Clause</u> after the OPEX clause or even in an appendix to the lease. This tenant would not be liable for the HVAC project expenses.	These types of leases will allow for capital expenditures that are undertaken to reduce operating expenses or effect other cost savings. These leases allow for cost savings and capital expenditures to be passed back to tenants over the course of their expected useful life. However, we have seen savvy tenants negotiate that <u>the cost reduction must be demonstrable</u> , and further that <u>the expenses are limited to the amount of the cost savings</u> . An HVAC retrofit for COVID-related concerns would not meet these thresholds and would therefore be borne by the landlord.	As you may have guessed, these leases are quite broad in what can be included, usually the only requirement being that the expenses need to be amortized over the project's or item's expected useful life. In these cases, the HVAC retrofit would be billable to the tenant. The only question would be the number of years the expense is amortized over, and perhaps the interest rate used.

HVAC retrofits are costly items, which could have a material impact on the tenants operating expenses over the course of the term. However, as demonstrated above, this often-obscure clause language can have a significant implication.

Do you know what your lease says about capital expenditures? Not knowing may be an expensive proposition. Reach out to our Lease Expense Reviewers for guidance or a review of your operating expenses pass-throughs.