

# CAPS ON EXPENSES

By David Liebman, SIOR, & Jim Hochman

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Welcome to the first in a series of articles on negotiation of lease clauses and contract provisions.

We are pleased to offer this forum to all active SIOR office and industrial professionals and associate members.

Our objective is to inform and suggest potential negotiating strategies to enable you to continue to represent your clients (landlord/seller or tenant/buyer) at the highest level. We welcome your feedback, questions, and comments in response to these periodic articles, as well as suggestions for future topics.

Our first article focuses on lease provisions which limit or cap capital and operating expenses. Capital expenditures (roof replacement, foundation and structure, and HVAC major repairs or replacement) are typically easier to identify in an office or industrial property by simple due diligence, on behalf of the tenant or buyer. For example, where a tenant contemplates a lease in a property with a 20-year old HVAC system, and the landlord seeks to impose both general operating and major repair/replacement costs on the tenant,

one option is to insert a “useful life” provision, such as: “The cost of any Operating Expenses that are capital in nature shall be amortized on a straight line basis over the useful life of the improvement, and only the amortized portion shall be included in Operating Expenses.” Typically, the tenant will want a longer useful life, such as the IRS’ schedule of depreciation, while the landlord will strive to impose its own (preferably, shorter) definition of the useful life. In either event, a defined “useful life” standard should be included.

Speaking of “Operating Expenses,” it is essential that the tenant’s broker carefully review and confirm up front the accuracy and nature of all such expenses. Often taken for granted, the laundry list of operating expenses can be lengthy and steps must be taken to ensure that the tenant’s exposure is not unreasonable under the circumstances. For example, management fees imposed by the landlord should be in line with both the market as well as the overall level of management exercised by the landlord or its property manager, and not just a source of extra revenue for landlord’s property management division. Additionally, some basic due diligence may uncover a rare but upcoming increase in insurance premiums due to a change in insurance carrier, which could impose unexpected higher CAM costs on the unsuspecting tenant. Overdue tuck-pointing expenses may arise in the first year of a multi-year lease term, a surprise to most tenants except for those who were properly informed by their broker or building

inspector. Lastly, be sure to confirm what expenses are not included (e.g., depreciation, mortgage debt service, brokers’ commissions, and improvements made for the benefit of specific tenants).

Most institutional and more sophisticated private landlords will protest their real estate taxes annually and charge the tenants with a proportional amount of protest costs. The lease might read: “Real Estate Taxes shall mean any general real estate tax or similar ad valorem tax lawfully assessed against the land and improvements comprising the Property, together with reasonable costs and expenses of contesting the validity or amount of the Real Estate Taxes.” Beware of upcoming periodic reassessment periods, at which time the protest costs can increase.

With regard to contesting of real estate taxes or other controllable costs, whether that right is vested with the landlord or tenant, the protest costs may be more than just the tax attorney’s contingent legal fees. In some cases, the landlord may impose upon the tenant other additional costs, such as tax appraisals that are ordered by the attorney or accountant in the protest process or simply required by the landlord’s mortgage lender.

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A final consideration is the tenant's right (NOT option) to audit and/or inspect the landlord's books and records to confirm and validate the expenses charged to the tenant. While few occasions arise to exercise such rights, it is essential that in such instances, the tenant and its financial professionals have reasonable access at reasonable times to the landlord's accounts, bills, and records to understand operating expenses, including potential landlord liability for tenant's audit expenses in the

event that expenses were overcharged by \_\_\_\_%. Be sure that a clear and equitable mechanism is included to handle over- or under-payments of expenses. In this regard, the auditing costs may be incurred by the property manager, or the tenant's or landlords respective accountants. When the tenant claims being overcharged by the landlord, some landlords will want those tenants to pay any and all costs incurred by the landlord or their accountant to prove the overcharges. Further, the landlord may

seek to include lease language that any auditing of the landlord's books by the tenant must be done through a named or "Big 4" accounting firm. Such provisions are intended to discourage many tenants from exercising their audit rights, when retaining such a firm usually requires substantial non-contingent fees. ▼

## ABOUT THE AUTHORS



**David Liebman**, SIOR, JD, LEED Green Associate, specializes in industrial property buyer and tenant representation, site acquisition, leasing, sales and build-to-suits. David enables his clients to make informed real estate decisions that fulfill all economic, functional, and logistical objectives. His accomplishments include: Completed transactions in excess of \$300,000,000 and 7,500,000 SF in the last 10 years alone; Lead Broker for Disposition of 283,000 SF Rand McNally Co. Corporate Headquarters; Winner of 2010 Wisconsin Industrial Transaction of the Year for the sale of 323,000 SF LEED Silver Warehouse.



**Jim Hochman, Esq.**, a partner of Arnstein & Lehr LLP law firm, practices law for a wide range of clients in real estate and real estate related litigation. Hochman writes freelance articles offering some of his best advice based on his 37 years of experience. He can be reached at [jahochman@arnstein.com](mailto:jahochman@arnstein.com).