

GROSS-UP PROVISIONS IN COMMERCIAL LEASES

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Introduction

In commercial leases, the landlord may require the tenant to pay the costs associated with operating the building as an additional payment to reimburse the landlord for paying the costs of operating, maintaining, insuring and furnishing utilities for the building. Frequently, the landlord remits the expenses and passes a portion or all of such costs of operating and maintaining the building through to the tenant. In a triple net lease, all of the operating expenses are passed through to the tenant each year. In a lease with an expense stop or base year, the landlord passes through to the tenant the amount of the operating expenses in excess of the expense stop or base year amount. For multi-tenant buildings, the landlord typically divides these charges among the tenants within the building. In other words, the lease allocates a certain amount to each tenant based on that tenant's proportionate share of the area within the building.

Many commercial leases, especially office leases, include a provision that allows landlords to "gross up" operating expenses. That is, if the building is not fully occupied, the landlord is empowered to gross up or overstate the expenses as if the building is fully occupied (or nearly full). As a result, because the actual cost of operating the building is grossed up to an amount that the landlord believes the operating costs would be if the building were 95% or 100% occupied (the exact percentage is negotiated by the parties), the amount that the tenant must pay, based on its proportionate share of the building, increases. If the building remains fully occupied during the entire lease term, the gross-up provision is not triggered.

The following example illustrates how a gross-up provision operates (assuming 100% occupancy):

<u>Occupancy</u>	<u>Actual Costs</u>	<u>10% Tenant</u>	<u>Other Tenants</u>	<u>Landlord's Portion</u>
100%	\$10.00	10% = \$1.00	90% = \$9.00	\$0.00
50% (without gross up)	\$5.00	10% = \$0.50	40% = \$2.00	\$2.50
50% (with gross up)	\$(10.00*)	10% = \$1.00	40% = \$4.00	\$0.00

*The actual cost is \$5.00 grossed up to \$10.00.

Only certain operating costs should be subject to the gross-up provision. Specifically, it should only include those expenses that vary by rates of occupancy within the building. Fixed expenses, which do not vary by occupancy levels, should not be grossed up. Examples of items that vary by occupancy and might be included are: electricity, utilities, trash removal, management fees, and janitorial services. Operating costs that do not vary by occupancy levels and, thus, should not be subject to the gross-up provision include amounts for taxes, insurance, and building security.

Landlord Considerations

A landlord benefits by including a gross-up provision in a lease because it shifts some of the responsibility of vacancies to the tenant. In the event that the building is not completely occupied, the gross-up provision allows the landlord to recover a portion of the operating costs for the vacant spaces from the existing tenants. For certain expenses, the gross-up provision is reasonable because the landlord may incur the charges for the entire building, even if it is only partially leased. For instance, if the building does not have separately metered electricity for each unit, the occupied units will require more electricity than the empty units. In such a situation, it is reasonable that the existing tenants pay more for such electricity usage rather than basing its costs solely on its proportionate share of the area occupied.

Tenant Considerations

Although ostensibly the gross-up provision only benefits landlords, it may actually benefit the tenant in certain instances. Specifically, the gross-up provision is important for a tenant that pays operating expenses based on a base year amount. After the landlord and tenant agree on the particular base year (typically the first year of the lease), the landlord, in subsequent years, passes through to the tenant the operating expenses that exceed the predetermined base year amount. Essentially, the tenant has fixed rent other than increases in operating expenses over the established base year amount.

Without a gross-up provision, if the building is not fully occupied during the base year, the tenant's expense stop will be low due to the lower occupancy of the building. If the building becomes fully occupied in a later year, the tenant's proportionate share will be calculated using the increase in operating expenses which results from increased occupancy of the building. By contrast, a gross-up provision allows the landlord to overstate the variable operating expenses for the base year, so the expense stop for operating expenses for subsequent years is increased. Consequently, it protects tenants from a spike in operating expenses.

In negotiating gross-up provisions the tenant should make sure that it is not responsible for any amount which is grossed up in excess of those amounts that the landlord actually pays. To enforce this concept, the tenant should have the ability to review the landlord's calculations with regard to the gross-up provision to make sure that they accurately reflect the parties' agreement. Finally, as a compromise, the landlord and tenant may agree to include a gross-up provision that allows the landlord to gross-up the operating expenses to a lower level of occupancy, perhaps 75% or 80%. That compromise amount would likely benefit both parties by leveling the amount of variable operating expenses.

Conclusion

It may not be common that a building or project is always fully occupied. As a result, a landlord has strong incentive to include a gross-up provision in a lease where the tenants are responsible for payment of operating expenses. A properly drafted gross-up provision in a commercial lease, however, can benefit both the landlord and, in limited circumstances, the tenant. Therefore, both parties should carefully consider such provisions when negotiating the lease.