

TYPES NOT MAPPED YET April 27, 2017 | TTR not mapped yet | Daniel T. Engle

Are 'Gross Up' provisions gross in commercial leases?

It is common in commercial leases for the tenant to pay a pro-rata share of the operating expenses of a building, in addition to base rent. Operating expenses include expenses incurred by the landlord in operating, repairing and maintaining, insuring, managing and providing utilities to the property.

In multi-tenant buildings, the landlord typically divides up the total operating expenses of the property, so that each tenant pays its pro-rata share of common expenses, based on the square footage of the tenant's leased space as a fraction of the total leased space within the building.

Commercial leases will often have a provision in the lease that permits the landlord to "gross up," or overstate the variable operating expenses of the property to the level of operating expenses that would have been incurred had the building been fully occupied for the year. Only operating costs that vary with the occupancy of the building should be subject to the gross-up provision in a lease. This might include, for example, janitorial services, trash, electric or other utilities. Things like building insurance premiums or real estate taxes do not vary with building occupancy and should not be operating expenses included under a lease gross-up provision.

How this works can be demonstrated by the following example:

Assume a tenant occupies 10 percent of the rentable space in the building and is responsible for 10% of the operating costs of the property, as tenant's pro-rata share of such expenses. Further assume operating expenses of \$100. If the building is 100 percent occupied, then the tenant would pay 10 percent of the operating expenses, or \$10. All of the operating expenses would be paid by the various tenants in the building and the landlord would pay \$0.

Now presume that the building is newly constructed and for the first year after completion the building is only 50 percent occupied. In this case, the variable operating expenses would \$5, rather than \$10. Without a gross-up clause in the lease, tenant would pay 10 percent of the \$5 in operating expenses, or 50 cents. The tenants occupying the other 40 percent of the building would pay \$2.00 (40 percent of \$5) of the operating expenses and the landlord gets stuck paying the other half, or \$2.50 of the operating expenses. Clearly, a bad result for the landlord.

With a gross-up provision in the lease, the landlord is able charge the tenants occupying the 50 percent of the building with "grossed-up" operating expenses of \$10, so that the 10 percent tenant's pro-rata share is \$1 (10 percent of \$10), the other tenants occupying the other 40% of the building pay a pro-rata share of \$4 (40 percent of \$10) and the landlord pays \$0 as a share of \$5 in variable operating costs.

The landlord benefits by a gross-up clause in the lease when vacancy is low in a building because it shifts some of the operating expense vacancy cost to the tenants who are under lease in the building.

The foregoing example shows that there can be a real benefit to a landlord from having a gross-up clause in the tenant's lease. But can the tenant also benefit?

The gross-up clause in a lease will benefit a tenant when the building operating expenses are included in a base year amount, with the tenant then only being responsible for its pro-rata share of operating expenses in excess of the base year.

For example, assume tenant moves into a new building that is only partially occupied, pursuant to lease with a base year for operating expenses and no gross-up clause. If the base year expenses are low because building occupancy in that first year is low, then when the building is fully occupied in a subsequent year, the tenant's pro-

rate share of operating expenses will jump significantly higher because of the increase in variable operating expenses for fully a leased up building, compared to the first year of low occupancy before completion of lease-up.

By having a gross-up provision in a lease, the tenant will be protected from a big spike in the tenant's share of operating expenses because a gross-up provision in the lease will cause the based year variable operating expenses to be overstated, so that in subsequent lease years the increase in variable operating expenses over the base year is reduced.

Frequently, in order to avoid a gross-up provision from overstating expenses actually paid by landlord, such a provision will be based, not on 100% occupancy, but on a lower occupancy of say, 80-85%. This compromise may have benefits to both landlord and tenant depending on the specific facts of the lease and the building.

While a "gross up" provision in a lease is not gross to a landlord, it deserves special attention and care from a tenant, and its legal counsel, prior to entering into a lease for new space.

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