"GROSS UP" PROVISIONS

IN OFFICE LEASES

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Few concepts are as confusing as the "gross up" of operating expenses

to those who do not regularly deal with office leases. Most tenants understand that in addition to base rent, tenants often directly reimburse their landlords for a portion of the building's operating expenses (e.g., real estate taxes, casualty insurance, maintenance, utilities, etc.). However, calculating such reimbursement for multi-tenant office buildings is less intuitive.

Defining "Gross Up"

Stated simply, the concept of "gross up" is that, when calculating a tenant's share of operating expenses for an office building that is less than fully occupied, the landlord first increases - or "grosses up" - those operating expenses that vary with occupancy (e.g., utilities, janitorial service, etc.) to the amount that such expenses would have been if the building were fully occupied. (In practice, "gross up" provisions are typically negotiated to reflect only 90-95% occupancy; however, for simplicity this discussion will consider only 100% occupancy.)

Understandably, many tenants' initial reaction is to question why any operating expenses should be increased above the amount actually incurred, suspecting that the landlord is trying to convert the operating expense reimbursement into a profit center. In reality, the "grossing up" of operating expenses is a fair and necessary mechanism to ensure that the intended reimbursement is fully paid and, in some circumstances, to protect the tenant from overpaying operating expenses.

How "Gross Up" Works

Consider a hypothetical 10-story office building with 10,000 square feet per floor, for a total of 100,000 square feet in the building. If this building were leased to five separate tenants, each having one floor, each tenant's proportionate share would be 10% (1/10 of the total building). Now suppose that the landlord's annual operating expenses for this building were $100,000, comprised of $75,000 for fixed expenses, and $25,000 for expenses that vary with the building's occupancy. If the operating expenses were not "grossed up," each tenant would have to pay its proportionate share of the $100,000 operating expenses, or $10,000 for each tenant, comprised of $7,500 for fixed expenses and $2,500 for variable expenses.

However, even if the landlord were to collect the full $10,000 from each tenant, it would only collect a total of $12,500 towards the variable operating expenses ($2,500 x 5), which is only one-half of the $25,000 in variable operating expenses that the landlord actually incurred. This results from the fact that each tenant's proportionate share is the ratio of the tenant's space to the total space in the building rather than the ratio of operating expenses attributed to the tenant's space to the total operating expenses for the building.

To correct this, the variable operating expenses should be "grossed up" to the amount they would have been if the building were fully occupied. In the example above, if the variable operating expenses were $25,000 where the building is one-half full, presumably they would have been $50,000 if the building were fully occupied. If each of the five tenants pays its 10% proportionate share of the "grossed-up" operating expense amount of $50,000, they would each pay $5,000, and the landlord would collect a total of $25,000 in variable operating expenses, which is the amount of variable operating expenses that the landlord actually incurred.

Variable vs. Constant Expenses

Note that, in the example above, the only expenses that were “grossed up” were those expenses that vary with the occupancy of the building. Operating expenses that are constant regardless of the level of occupancy - such as real estate taxes and insurance - should <u>not</u> be “grossed-up.”

This means that the existing tenants in a building that is less than fully occupied will not reimburse the landlord for the full amount of such fixed expenses actually incurred. This is appropriate because the “gross up” provision should not be used to shift the risk of vacancy from the landlord to the tenant. The landlord is obligated to pay taxes, insurance, and the like regardless of the building’s occupancy, and it is the landlord’s business to fill its building with tenants to cover these fixed operating expenses.

To the extent that a “gross up” provision in a lease provides that operating expenses will be increased to the amount such expenses would have been if the building were fully occupied, it may not be strictly necessary to specify that only those operating expenses that vary with occupancy will be “grossed up” (after all, a fixed operating expense, by definition, will be the same at full occupancy as at any other level of occupancy); however, it is good practice to state in the lease that only variable operating expenses will be “grossed up”, as well as specify which operating expenses are considered variable.

Tenant Protection

While commonly considered a landlord protection (albeit a fair one), there are certain circumstances where “gross up” protects the tenant from paying more than its intended share of operating expenses.

For example, in many office leases, the tenant is obligated to pay only its proportionate share of operating expenses over a certain base year (usually the first year of the lease term). Suppose that a building is not fully occupied in the base year and base year operating expenses are not “grossed up.” If the building’s occupancy subsequently increases, the variable operating expenses will also increase as the new tenants require services (in addition to the increase attributable to inflation, etc.), and, because the tenant must pay its portion of the increase in operating expenses over the base year, the tenant would be obligated to pay a portion of the variable operating expenses attributable to new tenants.

Assuming the landlord is reimbursed for those expenses by the new tenants under their leases, the original tenant's overpayment of operating expenses is a windfall to the landlord. Therefore, to prevent this unexpected spike in operating expenses in base year deals, tenants should ensure that the lease specifies that, in calculating the increase of operating expenses, the variable operating expenses for such base year and all subsequent years will be “grossed up.”

Contrary to a tenant's natural reaction,

the "gross up" of operating expenses in a multi-tenant office building is neither nefarious nor inappropriate. Rather, it is a mathematical necessity to ensure that the landlord receives full reimbursement for all of the operating expenses that vary with occupancy, as the parties intend. Moreover, where the tenant has negotiated for a "base year" with respect to operating expenses, the "gross up" of operating expenses actually protects the tenant from overpaying variable operating expenses as occupancy of the building increases after the base year.

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