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Gross Up Provisions in Commercial Lease Agreements: Guidance for Landlords and Tenants

Structuring Terms to Balance Benefits and Mitigate Risks

THURSDAY, SEPTEMBER 6, 2018

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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GROSS UP PROVISIONS IN COMMERCIAL LEASE AGREEMENTS: GUIDANCE FOR LANDLORDS AND TENANTS

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Net and Gross Leases

- Triple Net or Net Lease
  - ✓ Rent is net to landlord of all operating expenses
  - ✓ Tenant bears burden of operating expense increases
  - ✓ Triple net versus net
- Gross Lease
  - ✓ Rent includes all operating expenses
  - ✓ Risky for landlord – electricity costs sometimes excluded
  - ✓ Most common for short-term tenancy or sublet
- Hybrid Leases
  - ✓ Most common in industrial and office settings
  - ✓ Tenant pays pro rata share, sometimes with a cap
  - ✓ Tenant pays over a base year

Operating Expenses Defined

- Operating expenses versus CAM
- Typically negotiated in the lease, not term sheet
- Often general and broad in scope
- Determining tenant's pro rata or proportionate share – is tenant's denominator based on "leased" or "leasable"
- General categories of expenses:
  - Repairs, maintenance and replacement
  - Reserves
  - Operations
  - Insurance
  - Taxes
  - Capital expenditures
  - Administrative & management fees
  - Utilities
  - Overhead and employee benefits; bad debts; legal fees
  - "Green" initiatives
  - Advertising
  - Construction and supervisory fees; costs associated with other tenants

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Base Year Operating Expenses

- Tenant pays its pro rata share of the increases in operating expenses over a base year
- Base year also called "comparison year"
- What happens with new construction?
- Tax incentives should be considered
- Base year may be different for taxes and operating expenses
- Request 3 years of reconciliations from landlord
- Inquire as to whether landlord anticipates major improvements during term
- Does the base include capital expenditures already incurred and the amortization of same?
- Renegotiate base year upon renewal or option
- Office leases – consider loss factor for space in pro rata share calculation
- Industrial leases – consider high traffic users that might artificially increases maintenance expense
- Reconciliation – when issued?
- Delay in delivery of reconciliation
- Reconciliation – what should it include?
- When is shortfall or overpayment paid or reimbursed?
- Survival of tenant obligation following lease expiration

Fixed Operating Expenses

- Fixed deals are becoming more common
- Tenant has the benefit of "no surprises"
- Fixed operating expenses typically do not cover real estate taxes, insurance or utilities
- Real estate taxes and insurance are typically on a pro rata basis
- Office and shopping center leases – landlords often retain a right to adjust utility charges based on annual assessments of a tenant's usage
- Typically only the base and fixed increases are negotiated
- Considerations when negotiating the base and fixed increases
- Landlord runs the risk of not being fully reimbursed
- "Excluded Areas" in shopping center leases may affect pro rata share
- Differences with respect to "mixed use" properties
- Concerns with "office complexes" and hidden fees
- No audit rights

Audit Rights & Disputes

- Tenant dispute rights
- Tenant must pay disputed amount; no right to withhold
- Operating expenses should not be a profit center for landlords
- Limit recovery to 100% of actual expenses
- Audit rights limited to tenant and its authorized representatives
- How often are audits permitted?
- How long after receipt of reconciliation statement is audit permitted?
- Notice to landlord; location of audit
- Retention of records by landlord
- Use of an auditor whose fee is based on a contingency is typically prohibited by landlords
- Results delivered to landlord
- If overstated, landlord reimburses tenant for reasonable cost of audit fee – 3% to 5% is norm

Gross-Up Defined

- What is "gross-up"?
- Generally applicable to office leases
- Expenses that vary with occupancy are grossed-up to the amount such expense would have been if the building were fully occupied
- Real estate taxes and insurance should not be grossed-up because they are constants
- Typically negotiated at 90-95% occupancy
- How does "gross-up" work?
  - 5 story office building with 3 tenants each occupying 1 full floor of 10,000 square feet for a total of 30,000 square feet leased out of the 50,000 available
  - Each tenant's pro rata share would be 20%
  - Landlord would be collecting 60% of total operating expenses if the variable expenses are not grossed up.
  - Total expenses are $100,000 with $30,000 variable then landlord is collecting only $60,000 of which it is recovering only $18,000 of the variable expenses
  - Grossing up the variable expenses for 100% occupancy would increase the variable expenses to $50,000 and each if tenant pays 20% then landlord would recover $30,000 which is amount landlord actually incurred.
- Can gross-up benefit tenant?
- How does gross-up work with a base year?

How Gross-Up Works

- How does "gross-up" work?
  - 5 story office building with 3 tenants each occupying 1 full floor of 10,000 square feet for a total of 50,000 square feet of space
  - Each tenant's pro rata share would be 20%
  - Landlord would be collecting 60% of total operating expenses if the variable expenses are not grossed up.
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Tenant Protections

- Negotiate a "cap"
  - Typically limited to a category of expenses
  - What are "controllable expenses"
  - What are "uncontrollable expenses"
  - Will the cap be cumulative or non-cumulative
- Limit capital expenditures
- Paving – no more than every 5 years
- Administrative fee – what is the norm?
- Management fee – what is the norm?
- Exclude any expenses related to other tenants
- Excluded landlord's brokerage commissions and legal fees
- Reserves
- Ground rent and mortgage amortization