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Grossing Up Operating Expenses in Commercial Leases

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Gross-ups are adjustments to building expenses that are made when such expenses are below normal levels because of building vacancies and other factors.

When buildings have vacancies or one or more tenants perform certain standard building services themselves (e.g. nightly office cleaning), the mechanism in commercial leases designed to reimburse the landlord for operating expenses can malfunction, causing either undercharges or overcharges to the tenant, depending on the type of lease and the year in which the drop in expenses occurs. Gross-ups are intended to counteract this problem by adjusting expenses to what they would be in a normal, fully operational building, with the landlord providing all standard building services to all tenants.

In most commercial leases, tenants are required to reimburse their landlords for their share of building expenses. The reimbursement mechanism operates one of two ways, depending on the form of the lease:

- "Net" leases, in which the tenant is charged a percentage (based on its share of the total building area) of total building costs each year
- "Modified gross" leases, in which expenses are built into the rent (the rent is higher) and the tenant pays for its share of *increases in expenses* each year over the expenses for the base year.

For a full discussion of the differences between different lease types, see KBA's LeaseTip™ entitled "Demystifying the Difference between Net and Gross Leases."

When parts of a building are vacant or otherwise not receiving building standard services, the landlord's operating costs for the building are less than normal. This situation can be problematic when trying to calculate the proper share of building expenses for those tenants in occupancy and who are actually receiving all of the building services.

Grossing Up to Prevent Understated Tenant Reimbursements

If the reduction takes place anytime in a net lease, or in a year other than the base year of a modified gross lease, the tenant will pay less than its full share of expenses. That's because a reduction in overall expenses dilutes the tenant's proper share of these costs. Each tenant's respective share remains *fixed* based on its percentage of the entire building, even though its actual share *(based on only those tenants receiving services)* may be higher.

Of course, calculating each tenant's share as a percentage of *occupied* space, rather than total building space, could potentially fix this problem. However, it is an imperfect solution because tenants in occupancy would have to pay disproportionate shares of *fixed* building expenses. For example, a tenant who occupies 25% of a building, but due to vacancies is the only tenant in occupancy, would have to pay 100% of the expenses. Thus, this single building tenant would have to pay 100% of landlord's insurance costs for the property.

The better solution is to adjust the expenses to levels that would be present in a fully occupied building. Here, in a building that is only 25% occupied, the property insurance costs would remain unchanged, but the abnormally low service costs, such as cleaning expenses, would be adjusted or "grossed up" to what they would be in a fully occupied building. Now, the vacancy has no impact on the 25% tenant's obligations. Such tenant pays 25% of an undiluted amount – exactly what it would have paid had the building been full.

Every commercial lease should require that expenses be fully grossed up every year.

Grossing Up to Prevent Tenant Overbillings in Base Year Leases

Grossing up is especially important in base year leases to prevent windfalls to the landlord. In modified gross leases with base years, the tenant is required to pay for all increases in expenses over the amounts incurred during the base year (typically the first year of the lease). The idea is to provide a mechanism to protect the landlord against increases in costs due to inflation and other similar forces. Each year, the building expenses are compared to what they were during the base year, and the tenant pays its share (based on its percentage of the entire building) of any resultant increases. This mechanism keeps the landlord whole as costs rise.

If costs are suppressed during the base year due to building vacancies or other reasons, the base year will be abnormally low as compared to years where no such conditions exist. If expenses thereafter increase to "normal" levels, when each year's expenses are compared to the suppressed base amount, the increase for which a tenant is responsible becomes exaggerated. This causes an annual overstatement of the tenant's liability.

For example, if during a base year only 25% of a building needs to be cleaned, and the building fills up the following year, necessitating full cleaning, the cleaning expense will rise to four times its original level, even with no increase in cleaning rates by the vendor. The tenant who occupies the original 25% will be required to pay 25% of this quadrupled increase.

Furthermore, because the base year expenses are used to calculate the tenant's liability each year of the lease, this overstatement will occur every year of the lease term if the building remains fully occupied. This creates an annual windfall for the landlord at the tenant's expense.

To correct this, the base year expenses must be grossed up to normal full occupancy levels. The low cleaning expense would be adjusted to what it would be in a full building, as should be done every year. Then, if there is no increase in rates, the number will remain the same. If rates increase, the number will rise accordingly. Grossing up the base year expenses eliminates artificial increases and causes the expenses to rise only if normal market forces cause rates to increase.

Every base year lease should make a particular point to require that base year expenses be fully grossed up.

Fixed vs. Variable Expenses

Note that not all expenses vary in direct proportion to occupancy. Many have a fixed component—a part that is unaffected by occupancy. For example, while cleaning expenses may be highly variable, core building costs such as insurance or HVAC and elevator system repairs will not change significantly with variations in occupancy. Each expense must be examined closely to determine if and to what extent a gross-up adjustment of the actual expense incurred is appropriate.

The Building Owners and Managers Association (BOMA) has developed several suggested methods and calculations that some landlords are beginning to follow. However, a landlord's claim that it is following BOMA does not mean that its gross-up adjustments are correct. BOMA has three different approaches to grossing up costs, and the one chosen by the landlord may not be appropriate. Also, even though BOMA warns landlords to consider all of the relevant factors in performing gross-up calculations, many landlords simply follow BOMA's generic formulas and forms without considering if they make sense in the circumstances.

Grossing Up for More than Occupancy

As mentioned above, occupancy is not the only factor that causes expense levels to be unusually low. Warranty coverage of new building systems temporarily reduces maintenance costs and must be adjusted. Also, in cases where management fees are calculated as a percentage of revenue, free and reduced rent periods will reduce management fees and must be adjusted to full rent levels. Again, each expense must be carefully examined to ensure that these abnormalities are addressed to keep the pass-through/escalation clause operating as intended.

Conclusion

Grossing up is a necessary adjustment that should be required as part of the operating expense (as well as tax and utilities) reimbursement mechanism of every commercial lease. It ensures that landlords receive full reimbursement of their expenses, and that tenants do not pay more than intended.

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