

GROSS UP CLAUSES: A METHOD FOR EQUITABLE COST SHARING BETWEEN LANDLORD AND TENANT, OR ACCOUNTING MAGIC FOR LANDLORDS?

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In our many years of working on commercial leases, as both broker (David) and as counsel (Jim) for many parties, we wrestle with the concept of “gross up.” Is it—indeed can it be—a fair way to allocate variable building expenses between landlord and tenant? Or—as many tenant advocates say—is gross up just accounting magic that allows a landlord to pass along to existing tenants the landlord’s costs of ownership attributed to vacant space? We have read many articles, usually written by landlord advocates trying to justify the practice as fair and one that does the tenant a big favor. Whether gross up is fair or foul depends on a number of factors.

Simply stated, gross up occurs when a landlord—in calculating a tenant’s share of operating expenses in a building which is less than fully occupied—first artificially increases, or “grosses up,” those operating expenses to the amount that such expenses would have been if the building were fully occupied. At first blush, this is simply a device by which a landlord passes on the variable expenses for vacant space—pro rata to existing tenants—thereby reducing landlord expenses and reducing landlord’s economic burden attributed to vacant space. Rarely is gross up negotiable: landlords simply stand their ground and insist that it is an integral term in

the lease. Tenants—even when well represented—can only mitigate the pain in small increments: cap the gross up at 95 percent or even something lower, or better, limit application of gross up to only expenses that vary with occupancy, such as utilities, janitorial service, trash removal, and the like. In a triple net office lease, the well-represented tenant likely still gets hurt by gross up, but the advocate minimizes the bleeding. Yet, the tenant still bleeds. Landlords offer a blandishment, such as that gross up protects a tenant from a big spike in the tenant’s share of operating expenses because the increase in these occupancy costs is reduced. Yes, the landlord reduces the tenant’s pain in these later years, by extracting tenant dollars from the start of the term—even when these expenses aren’t fully incurred! It reminds us of the mother’s words right before administering a spanking to her child: “This will hurt me more than it hurts you.” We didn’t believe it then, and we don’t believe it now.

In our opinion, there is one circumstance where gross up protects a tenant, and really, only one. If rent is calculated on a modified gross basis, where the tenant’s share of operating expenses is calculated on that amount which exceeds a base year; then if these variable operating expenses are grossed up to form the base

year, then—and only then—does gross up actually save the tenant money, assuming the base rent is fair and not inflated. In fact, this principle was applied to a recent pediatric office space lease renewal handled by co-author David.

While the practice still troubles us, its harsh effects are tempered—first in a modified gross lease where occupancy is low—and second when the expenses grossed up are limited to agreed variable expenses. A landlord who insists on gross up will rarely change accounting practices for one tenant, but the well-advised tenant either insists on a modified gross lease, or limits the bleeding with limited variable expenses.

Understanding gross up is important and will help a well-trained broker to provide a meaningful comparison to his/her client between a net lease deal with gross up and a modified gross lease at the second building. It pays to understand gross up, even if you don’t like it, and even if it just doesn’t seem fair. ♥