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Understanding Gross Ups and Expense Caps

Gross Ups and Expense Caps are common, yet often misunderstood, provisions in commercial leasing transactions. This is intended to offer insight and practice tips for the broker, property manager and lease negotiator who may encounter these concepts.

Gross Up Provisions

The purpose of a "gross up" provision is to allocate to a tenant only the amount of operating expenses that is properly attributable to the tenant's occupancy of the building. Negotiating for a gross up is appropriate where the tenant is paying for its share of operating expenses over a base year amount.

Practice Tip: When to negotiate for a gross up provision:

Base Year Occupancy	Landlord	Tenant
Low Occupancy		✓
High Occupancy	✓	

It should be noted, though that grossing up results in a fair allocation of expenses for both landlord and tenant, regardless of which party initiates the negotiation.

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A typical gross up provision permits the landlord, for accounting purposes, to increase (or gross up) the amount of variable operating expenses to reflect 90% to 100% building occupancy. Variable operating expenses are directly related to occupancy of the building, such as janitorial expenses and utilities, as opposed to expenses like property taxes, which are not related to building occupancy, and therefore not appropriate for a gross up provision.

Practice Tip – A fair gross up provision should:

- State that the landlord cannot recover more than 100% of actual expenses
- Stipulate that the gross-up applies only to variable expenses and defines "variable expenses"
- Provide that the base year and all subsequent years must be "grossed up" and the percentage should be clearly stated (typically between 90% and 100%)

Below is an example of how **a gross up provision benefits the landlord if the building has high occupancy during the base year and occupancy subsequently declines**:

In the base year, the building is 90% occupied. In Year 2, occupancy declines to 70% of the building. The decline in occupancy could result – without a gross up provision – in a loss to the landlord with regard to variable operating expenses recovery. A gross up provision allows the landlord to recover some operating expenses from its remaining tenants.

*because actual Variable Operating Expenses are less than the Base Year amount

Below is another example, showing how **a gross up provision benefits the tenant if the building has low occupancy during the base year and occupancy increases**:

In the base year, the building is 25% occupied. In Year 2, occupancy increases to 90%, with a corresponding increase in variable operating expenses. The increase in occupancy could result – without a gross up provision – in a

	100% Gross-Up		No Gross-Up	
	Base Year	Year Two	Base Year	Year Two
Actual Variable Operating Expenses	$90,000	$75,000	$90,000	$75,000
Building Occupancy	90%	70%	90%	70%
Grossed-Up Variable Operating Expenses	$100,000	$107,143	--------	--------
Tenant's Pro-Rata Share	70%	70%	70%	70%
Tenant's Variable Operating Expenses Payment	--------	$5,000	--------	$0*

*because actual Variable Operating Expenses are less than the Base Year amount

significant increase in the tenant's operating expense payment obligation. A gross up provision protects the tenant from such a steep increase.

He who laughs last, thinks slowest.

Expense Caps

Negotiating for a cap on operating expenses is another way for a tenant to manage risk and maintain a level of certainty in its monetary lease obligations. Typically, caps apply only to controllable operating expenses, such as landscaping and cleaning expenses.

One of the most common types of caps is a Compounded Year Over Base Cap, in which the cap percentage is compounded each year, allowing for a more rapid increase in the capped expenses.

	100% Gross-Up		No Gross-Up	
	Base Year	Year Two	Base Year	Year Two
Actual Variable Operating Expenses	$21,250	$90,000	$21,250	$90,000
Occupancy	25%	90%	25%	90%
Grossed-Up Variable Operating Expenses	$85,000	$100,000	--------	--------
Tenant's Pro-Rata Share	25%	25%	25%	25%
Tenant's Variable Operating Expenses Payment	--------	$3,750 (25% of the $15,000 increase based on the gross-up expenses)	--------	$17,188 (25% of the $68,750 actual increase with no gross-up)

Example: If base year expenses are $100,000 and the parties have agreed to a cap of 4% over the base year expenses on a compounded basis, the caps are calculated as follows:

Base year expenses: $100,000
Year 2 capped expenses: $100,000 x 1.04 = $104,000
Year 3 capped expenses: $100,000 x 1.0816* = $108,160

*Represents a 4% increase over the prior year's 4% cap. Year 4's cap will be 4% over the Year 3 cap percentage, and so on.

The compounding year over base cap provision is the most landlord-friendly because it allows for the fastest increase in capped expenses, permitting the landlord to pass through more expenses to the tenant. This method is also referred to as a "compounded and cumulative" cap.

<u>Practice Tip</u>: A well drafted expense cap provision should:

- Clearly describe how the cap is to be computed and applied
- Identify what <u>types</u> of expenses will be capped and clearly define those expenses if there is a limitation (e.g., "controllable operating expenses")
- Include a sample computation

Alternatively, a "Year Over Year" cap is more tenant friendly because it is keyed to actual, prior year expenses and could therefore result in lower caps (and fewer expenses passed through to the tenant). If actual expenses fall below the cap, the capped amount for the next year is calculated on the lower, actual expense amount, resulting in a lower cap for the following year. The example below demonstrates this concept with a cumulative year over year cap.
Example: If actual base year expenses are $100,000 and the parties have agreed to a cumulative year over year cap of 4%, the caps are calculated as follows:

Base year actual expenses: $100,000
Year 2 capped expenses: $100,000 x 1.04 = $104,000

If Year 2 expenses are actually $102,000, and the cap is not reached, then the parties will calculate the Year 3 capped expenses based on the $102,000 in actual Year 2 expenses:

Year 3 capped expenses: $102,000 x 1.08 = $110,160

If Year 2 expenses are $106,000, however, then the Year 2 cap will apply, and the parties will calculate the Year 3 capped expenses based on the $104,000 cap for Year 2.

Year 3 capped expenses: $104,000 x 1.08 = $112,320

While these two examples are the most common in the current market, there are other variations on expense caps, such as a cumulative year over base, and a compounding year over year cap. The parties may also negotiate to allow the landlord to recover "unused" percentage increases (in a year in which expenses are below the cap) by making up the difference later in the term if operating expenses increase above the cap.

Both Expense Cap and Gross Up provisions require careful consideration, negotiation, and drafting to ensure that the parties understand the bargain and that the written lease accomplishes their intent.

DIVERSIONS *Hold The Pickles!*

Two tourists driving through Louisiana were approaching the town of Natchitoches and began arguing about how to pronounce the name of that town. They were still arguing when they stopped for lunch, so while standing in line at the counter, they decided to settle the issue by asking the employee.

"Before we order," said one of the men, "please settle an argument for us. Would you please pronounce the name of where we are? Slowly, please."

The employee leaned over the counter and said, "Burrrr, grrrr. Kiiiing."