

The Operating Cost (Gross-Up) Clause

Why is the Landlord insisting that they can increase costs they will recover as part of their additional rent?

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Generally, leases are drafted to protect Landlords, and it may be a challenge to know what you can negotiate and what you may have to live with in a standard lease. Missing a critical clause can be costly in the future. We always recommend you have a lawyer, preferably one who deals specifically with commercial leases, review your lease.

Over many years of dealing with different lease forms, we've come across a variety of common concerns. This article will cover one of the clauses that have caused both our clients' blood to boil and has had lawyers not accustomed to commercial leasing complaining about the language. This clause is usually found under "Additional Rent" or "Operating Costs," or will be included within those definitions, and worded as;

"Operating Costs" means the aggregate of all costs in a fiscal year, calculated as if the Building were one hundred percent (100%) occupied by tenants throughout such fiscal year..."

"If less than 95% of the rentable area of the office tower is occupied during any period for which a computation must be made, the number of operating expenses will be increased by the amount of the additional costs determined by the Landlord, that would have been incurred had 95% of the rentable area of the office tower been occupied during the that period..."

"If there are any vacancies in the Building, and because of such vacancies the operating cost is less than it would have been if the Building has been fully occupied, then for the purpose of determining the amount payable by the Tenant under this clause, the operating cost for the relevant accounting period shall be increased by the amount of any savings in the operating cost for such period attributable to such vacancies (as determined by the Landlord acting reasonably)..."

"If less than 100% of the Building is occupied by tenants, then those components of operating costs which vary according to the degree of occupancy

of the Building shall be deemed to be increased to an amount as estimated by the Landlord, acting reasonably, which would have been incurred had 100% of the Building been occupied by tenants throughout the entire period for which operating costs are being calculated."

The above samples, which we call the "gross-up clause", seem to suggest that the Landlord can charge or recover more than they should in operating costs, appearing as though the Landlord is attempting to take advantage of the tenant.

This wording begs the question: If a multi-tenanted building has vacancies, should the Landlord be able to increase the cost to the tenant? The answer lies in understanding the whole lease, and the clause pertaining to operating costs or the definition of such cannot be read in isolation. To understand this principle that each net lease tries to convey, one must also review proportional share and understanding how the Landlord can recover each tenant's proportional share of a cost.

In a net lease, if a tenant occupies 10% of the rentable area, then the tenant is responsible for 10% of the Additional Rent - the aggregate of the taxes and the operating costs. A typical definition of the proportionate share may be defined as:

"Tenant's proportionate share means an amount determined by multiplying operating costs for the fiscal year by a fraction having as its numerator the square feet in the Premises and having as its denominator the square feet in the building.

Or "proportionate share" means that fraction having as its numerator the rentable area of the leased premises and having as its denominator the rentable area of the leasable premises, provided that the Landlord shall be entitled, acting reasonably and equitably, to adjust such fraction in the event the Landlord determines the Tenant is receiving a greater or lesser benefit than any other tenant(s) or occupant(s) of any service or area.

So, what does this all mean? Let's take a simple expense that may vary according to occupancy. For example, a janitorial contract that is based on cleaning the common areas and tenant's premises. The contract is on a per square foot basis of occupied premises and charges \$2.50/SF per annum. In our example, we use a 100,000 SF building and assume that Tenant "A" occupies 10,000 SF and 25% of the building is vacant. How much would Tenant "A" be paying for the janitorial costs? Below we have calculated the two outcomes, with and without the gross-up clause, which are starkly different.

Without the gross-up clause;

- ▶ Tenant's proportionate share 10,000 SF/ 100,000 SF = 10%
- ▶ Janitorial costs \$2.50/SF X (100%-25% vacant) X 100,000 SF = \$187,500
- ▶ Tenant's proportionate share 10% = \$18,750
- ▶ Other tenants 65% = \$121,875
- ▶ Landlord recovers \$140,625, and there is a shortfall of \$46,857

With the gross-up clause, the language under the definition of operating costs allows the Landlord to increase the variable costs as if the building were 100% occupied. Using the above example, the recovery calculation would look as follows:

- ▶ Tenant's proportionate share 10,000 SF/ 100,000 SF = 10%
- ▶ Janitorial costs grossed-up to 100% occupancy \$2.50/SF X (100%) X 100,000 SF = \$250,000
- ▶ Tenant's proportionate share 10% = \$25,000
- ▶ Other tenants 65% = \$162,500
- ▶ Landlord recovers the full amount of \$187,500

The intent of the gross-up clause is not to overcharge but to recover those variable costs that without the wording could not have been properly recovered. The challenge is that the wording allows the landlord to estimate costs and it takes a bit of faith in the Landlord-Tenant relationship to accept that the former will act reasonably. At the end of the day, the lease governs, and a tenant relies on operating costs falling in line with the market. Interestingly, when the market is tight with low vacancy, and there are few options, the operating costs tend to spike, and when there are vacancies, the landlord works harder to keep their additional rents under control to attract tenants.

This is just one clause out of hundreds in a typical lease. Hopefully, this article has provided you with some comfort and guidance as to why the lease is worded the way it is.

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Without the gross-up clause

\$187,500	Vacancy 25%	\$0
	Other Tenants: 65%	\$121,875
	Tenant A: 10%	\$18,750

There is a shortfall of \$46,857

With the gross-up clause

\$250,000	Vacancy 25%	\$0
	Other Tenants: 65%	\$162,500
	Tenant A: 10%	\$25,000

The Landlord recovers the full amount of \$187,500

Contact us today to learn more about how we can represent your interests.



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