2020 LEASE AUDIT SPOTLIGHT

Gain Clarity on Gross-up Adjustments

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A commercial office tenant had leased 10,000 square feet of space in a partially occupied building, and it switched all staff to remote work at the outbreak of the COVID-19 pandemic. The company only had one employee physically present in the office between April and December—an information technology specialist who needed to perform checks and maintenance once per week. The landlord considered this office space to be unoccupied and provided a reduced level of services due to the drastic reduction in utilization. Under the gross-up provision in tenant leases, the variable expenses for these services were increased to reflect the cost that would have been incurred at full occupancy. Is this treatment appropriate?

2020 brought disruption in droves. Among the many challenges that businesses have faced, the impacts on commercial real estate introduced a broad range of anomalies. The COVID-19 pandemic unexpectedly and immediately forced dramatic shifts in physical occupancy and utilization of office space as organizations scrambled to adapt. After landlords and tenants pivoted from their standard operations, some of the changes in the workplace will be long-lasting and are now coming into focus.

In particular, gross-up clauses in many commercial leases have increased the complexity of operating expense reconciliations because of the unforeseen disruption during 2020. These clauses are an ordinary provision in many commercial leases that must now account for extraordinary changes in building operating expenses. The disruption has continued into 2021, so it is advisable for tenants to seek transparency on this issue as soon as possible.

With year-end reconciliation statements being issued by landlords, it's critical for tenants to have a full understanding of the gross-up adjustments at all office properties where they lease space. Even during "normal" circumstances, a gross-up adjustment requires a keen understanding of building operations, services provided and physical occupancy. Unfortunately, the gross-up calculation can be subjective and given little thought by tenants, but it should become a priority now to examine the lease language and review those reconciliations to ensure they have been calculated fairly. Conducting a lease audit can not only provide greater clarity about a tenant's financial obligations, it could result in significant cost reductions.

UNDERSTANDING GROSS-UP CLAUSES

Gross-up clauses in leases are intended to result in the consistent treatment of building operating expenses that vary with occupancy levels, such as janitorial, utilities, certain management fees and more. For fixed operating expenses that do not vary with occupancy, such as security and insurance, a gross-up would not typically be needed. As noted below, a gross-up is usually calculated based on the portion of the building that is either leased or occupied.

When a building is fully occupied, a gross-up is often not needed. But when a building is less than fully leased or fully occupied, the landlord may calculate a gross-up adjustment to those applicable operating expense categories to project those costs that would have been incurred had the building been fully occupied (as specified in the lease).

A simplified example in the chart below shows why a gross-up would be equitable in a building with variable operating expenses of $100,000 annually and the subject tenant occupying 50% of the building:

Occupancy	Variable Operating Expenses	Subject Tenant's Share @ 50%	Other Tenants' Share	Landlord's Share
100%	$100,000	$50,000	$50,000	$0
50% (no gross-up)	$50,000	$25,000	$0	$25,000
50% (+ gross-up to $100,000)	$50,000 (+ $50,000)	$50,000	$0	$0

Without the gross-up, you will note the subject tenant paid only half of what it would have paid when the building was either fully occupied or properly grossed up. Without the gross up, the landlord would absorb a portion of variable operating expenses attributable to the tenant in occupancy.

These clauses, when implemented properly, can offer protection to both landlords and tenants by allocating the variable operating expenses to those who benefitted, thereby protecting both sides from significant variations from year to year should occupancy change. If the gross-up has been done correctly and is consistent with the lease language, neither side would leverage unfair gains. However, because there are so many variables and the operation of each building is unique, having transparency and a full understanding of the information supporting the gross-up is critical.

THE COMPLEXITIES OF GROSS-UP RECONCILIATIONS SPECIFIC TO 2020 (AND 2021)

Most landlords had established an estimated operating budget for 2020 before the start of that year, expecting 2020 operating expenses to be very similar to 2019, perhaps incorporating some inflationary increases. But those estimated budgets underwent significant upheaval as landlords and tenants adapted to pandemic-related changes and uncertainty. During 2020—and 2021—more costs must be examined and evaluated particularly for gross-up considerations than would have been previously.

Adapting amid uncertainty entailed many decisions and intricacies that affect gross-up calculations, so it's important to gain insight about the landlord's methodology for operating expense adjustments and reconciliations. The details of those decisions likely did not have corresponding prescriptive lease language, which typically provides only generic guidance about variable expenses. The unique nature of 2020 therefore raises the potential for more disputes over those decisions and the related gross-up.

Specific complexities in gross-up reconciliations include:

Determining Physical Occupancy and Utilization

The standard gross-up provision generally assumes that leased space will be fully occupied and used by the tenant, but that was not the case during 2020. Directives from government authorities and public health agencies placed restrictions on in-person work for non-essential businesses, and these varied from state to state and county to county over time. Even when some businesses returned to work, many had reduced density and employed hybrid work models that combined remote options with in-person presence.

As a result, while the amount of leased space remained the same for many properties, the levels of physical occupancy and utilization declined significantly. Most buildings remained open and available for much of 2020, but landlords had to assess their adjustments of operating expenses according to physical occupancy and usage, which varied widely.

The vast majority of tenants may have had a skeleton staff in the office to perform core operations, such as IT workers to monitor and support necessary systems. Those staff members may have been in the office on a daily basis, or possibly only once a week or once a month, perhaps only for a few hours at a time. Does the landlord still consider that leased space to be physically occupied, and did they account for utilization proportionally?

That's why tenants need to understand how other building tenants were using the space, how landlords made corresponding service changes and how variable operating expenses were grossed up. In some cases, tenants may be entitled to receive the vacancy credits issued by the cleaning vendor or other offsets, and lease language can provide some clarity about that.

Understanding Service Levels for Variable Expenses

With so many unpredictable variables, tenants need comprehensive information about the service levels that the landlord delivered to their tenants. This information should include how contracts with vendors affected those adjustments, and whether any fixed-contract prices were renegotiated in light of reduced need.

Regarding utilities, tenants should know if heating or air conditioning was supplied as normal, extended or provided on a reduced, as needed basis. They should also seek information about electricity usage throughout the building and whether that remained the same.

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Take janitorial expenses as an example. Did the landlord have office space cleaned on a regular basis, and did they pay the vendor the same amount as previously? If so, there would not be a need to gross up the costs that were incurred. Or were those janitorial services provided on an ad hoc basis, corresponding to physical occupancy and utilization of the space? If the landlord had the vendor perform fewer cleanings and the scope reduced, should the tenant pay a gross-up for a service that was not provided, and for a cost that was not incurred? This is clearly a situation that requires a conversation between the landlord and the tenant.

Building management costs are another area to consider. Although personnel costs are not typically a variable expense, many landlords likely had lower costs due to a reduced need for administrative, security, maintenance and engineering staff in light of physical vacancies and lower utilization. However, there may be other factors that impact this, such as bonuses or overtime for remaining building personnel. Even comparatively minor factors should be considered, such as a lack of seasonal decorations, office parties and other periodic events.

2020 Base Year Considerations

With a gross lease, the base year should reflect the cost of normal building operations, but in cases where 2020 was the base year, there may be expenses that are lower than usual. That means tenants could see significant annual escalations during the lease term when normal building operations resume.

Getting an accurate representation of applicable operating expenses during the 2020 base year will help to understand how those may be impacted over the remainder of the lease. Even though this year's determination is more complex than usual, understanding how the landlord addresses these complexities to make consistent and reasonable comparisons throughout the lease term will help avoid potential surprises.

TRANSPARENCY FOR 2020 PROVIDES CLARITY FOR THE FUTURE

There were more variables and complexities for commercial real estate in 2020 than ever before. Some tenants may expect to see operating expense reductions, but that's not a certainty because of gross-up provisions. Even if total property operating costs decrease from prior-year levels, a detailed review is needed to understand if an increase in one area is being offset by a decrease in another. Reviewing applicable lease language will be critical for tenants in determining what their obligation might be with respect to grossed-up operating expenses.

It will be helpful to get detailed documentation about operating expenses for 2020 and compare those to the prior year. Armed with that information, tenants can better evaluate what services were provided and what they're being charged for.

It's beneficial to conduct a lease audit promptly, as some leases may set a deadline to review the reconciliation or challenge the gross-up calculation. Ideally, landlords should have a documented policy outlining how gross-up provisions are implemented to fairly account for the exceptional nature of 2020 operating expenses, but that may not be the case. Using experienced advisors to review lease language and gross-up reconciliations in detail can help tenants gain transparency and ensure accuracy both this year and in the years ahead.

Learn more about how lease auditing can help bring clarity to changes in building operating expenses, how the gross-up provision applies and your responsibility for paying the cost. You can also consult our checklist: Are You Prepared for a 2020 Lease Audit?

READ MORE

In our previous Lease Audit Spotlight, we examined the cost of amenities and the importance of assessing how landlords accounted for changes in usage and availability during 2020.

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