COMMERCIAL LEASE GROSS-UP

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Because commercial leases are long-term contracts, they sometimes become long and arduous documents as each and everyone try to cover multiple possibilities. Bill Tresham, a former colleague of mine, used to jokingly repeat to me before signing a lease that "the devil is in the details." And it is so true! Without any doubt, leases invariably may include details that can make just about anyone fume. So, here are a number of items of "details" dealing with rent gross-up which form an integral part of commercial leases and which must be taken into consideration.

In fact, in terms of net leases, there are three types of gross-up: the gross-up with respect to the calculation of the surface area, the gross-up with respect to the calculation of the proportionate share and the gross-up with respect to various operating costs. Even though this last one may sometimes be deemed financially insignificant, its absence in a lease may result in unexpected consequences unacceptable to any landlord, particularly those landlords leasing office spaces. Furthermore, any gross-up in the calculation of the surface area and in the proportionate share inevitably result in tangible increases in rental costs.

1. Gross-Up Related to the Calculation of the Surface Area

The leased premises usually refer to either a net rentable area or a gross rentable area. In terms of office leases, the area actually occupied (the net rentable area) is often grossed-up in order to determine the gross rentable area. The gross-up is carried out when the space leased is first measured, as this will have a direct impact on the net rent, the operating costs and the real estate taxes payable. When calculating the floor rentable area according to the 1980 or 1996 BOMA rules of measurement, it is recognized that the landlord will be entitled to include a certain percentage in order to take into account the various common areas of the building. In fact, if one assumes that the measurements were based on the BOMA 1996 rules of measurement, the landlord has the right to increase the net rentable area in such a way as to prorate the common areas of the hallways on the floor where the rented space is located, as well as other areas such as, the lobby of the building, the mechanical rooms and the washrooms. It is usually an increase of more or less 10% of the usable area occupied by the tenant within the rented space. It is therefore important when drafting an offer to lease or a lease to specify the rules of measurements that will apply, considering that these rules of measurement will have a direct impact on the gross rent payable by the tenant. In any event, as I mentioned in a previous article, it is important to promptly measure the leased premises as failing to do so would result in the impossibility to apply such gross-up at a later date. (See, Jean-Pierre Riel, The Importance of Measuring the Leased Premises, eSpace Montréal, Vol. 17, No. 3, 2008).

Sometimes the parties may agree on a predetermined gross-up percentage, yet one must make sure that this gross-up is reasonable.

As far as retail commercial leases are concerned, the area upon which the rent is paid is generally the space occupied by the tenant; in other words, there is no gross-up. Nevertheless, we are beginning to see a trend where some

landlords have taken it upon themselves to include the gross-up of certain costs in order to take into account common areas, such as mechanical rooms and washrooms. We find this to be the case in certain power centres although generally this gross-up is less than that found in office leases.

2. Gross-Up Related to Operating Costs

There are cases where the landlord, when calculating operating costs, may be treated unfairly. This can happen when applying operating costs which vary depending on the rate of occupancy of a building. In fact, these operating costs compel landlords to provide for a clause specifically dealing with increases resulting from operating costs, commonly called "gross up", to allow landlord to recover 100% of these expenses. Sometimes leases contain a gross-up clause of 95% and the reason for using such percentage (instead of 100%) is to take into account a vacancy rate of approximately 5%.

Since the type of expenses which may be subject to gross-up are essentially expenses related to operating costs which vary according to the building's occupation rate, the best example hands-down is the cleaning cost (janitorial services). In fact this expense will vary substantially in the case of a building being occupied at 100% compare to a building being occupied at 50%. Let's take the example of a building containing 100,000 square fee is rented to two tenants, each occupying 50,000 square feet, where the cleaning and maintenance costs per year amount to one dollar per square foot; this represents a recoverable expense to the landlord of $100,000. Consequently, the tenants will each have to pay $50,000 in terms of operating costs for cleaning. If one of the tenants leaves the building, half the building will then become vacant, and the cleaning costs will no longer be $100,000 but $50,000 instead, assuming that the vacant space will not be cleaned. Since the remaining tenant occupies 50% of the building, it would normally have to assume 50% of such costs that is 50% of $50,000 or $25,000. This would be unfair to the landlord, as he would therefore have to assume, at his cost, half the cleaning costs, when in fact the tenant is the sole beneficiary of such service. Therefore, the inclusion of a gross-up clause in the lease will allow the owner to increase the operating costs in such a way as if the building were 100% occupied thereby allowing him to double the amount of the invoice issued by the company providing janitorial services and therefore to find himself in the same situation as when the building was entirely rented.

Consequently, the absence of a gross-up

clause of the operating costs could have a significant negative effect for the landlord and prove to be manifestly unfair to him. It is important to note again, that only variable costs must be part of a gross-up clause and it is important that it be specified. Hence, any expense which does not fluctuate with the occupation rate of the building must be excluded from such gross-up clause relating to operating costs. The landlord and the tenant must, therefore, make sure that this gross-up clause is well-drafted in terms of these considerations.

3. Gross-Up Related to the Calculation of Proportionate Share

It is essential to determine the area within which operating costs will be taken into account. In an office building, the calculation is generally quite easy and simple, considering that all expenses relating to the building are accounted for. For example, a parking lot will generally be excluded from the operating costs, as it is usually considered a profit centre.

In commercial shopping centres, the situation can be quite complicated. In fact, the determination of what actually constitute a shopping centre may vary considerably. This is particularly the case with major tenants which are not included in the determination of the gross rentable area of the building for purpose of calculating the proportionate share of operating costs. For example, in shopping centre leases, the area occupied by major tenants would not be considered in the calculation of the proportionate share (i.e. in terms of the denominator)—this is usually the case for anchor tenants such as Sears or Canadian Tire, but it can also be the case for tenants whose leased area exceeds 15,000 square feet. This has a real impact in the calculation of operating costs and taxes considering that the proportionate share will increase.

This is totally justifiable as these major tenants often pay gross rent or a lesser overall gross rental, their presence serving as a boost in the sales figures of smaller tenants. The tenant must make sure that he agrees with this method of calculation since it will have a direct impact on rental rates. Thus, the calculation of operating costs will be prorated among the smaller tenants, excluding the major tenants. This exclusion of anchor tenants is often predetermined in the original conception of the shopping centre. Nevertheless, this type of exclusion may also be found within the lease and more particularly within the clause outlining the proportionate share. In the recent decision rendered by the Superior Court in Canada – Les Halles Co. v. 9015-6720 Québec Inc. and Michel Desjardins Ltd., the Court needed to rule on a landlord's interpretation and application of a clause contained in a lease usually referred to in the industry as the "net de locataires majeurs" clause. It reads as follows:

"1.1.24 "Proportionate Share": a fraction where the numerator represents the gross rentable area of the leased premises, and where the denominator is the gross rentable area of the shopping center, with the exclusion of basements or garages (...);"

(...)

"1.1.29 "Gross Rentable Area of the Shopping Centre": the sum of all the gross rentable areas designated for tenant occupancy of the shopping centre, measured according to the method described under subparagraph 1.1.28, excluding the following elements: a) the areas occupied by movable kiosks, b) areas leased to supermarkets, department stores, variety stores, and generally speaking, all leasable areas or areas intended for leasing exceeding nine thousand square feet (9,000 sq. ft.), c) all areas rented to the Federal, Provincial or Municipal governments, governmental agencies, Crown corporations, public agencies and organizations and federal or provincial para-governmental organizations, d) areas whose façade does not give on the inside of the mall and e) surface areas devoted to community, public or religious services even if they are rented;" [Translation]

Therefore, the landlord established the denominator in the fraction referred to at section 1.1.24 of the lease at 44,116 square feet and in order to come to this total, the landlord excluded the areas described at section 1.1.29. The tenant countered that although it understood the application of the "net de locataires majeurs" clause, the tenant affirmed that since the acquisition of the shopping centre by Les Halles, who is seeking the application of this clause, the operating costs have doubled. In its decision, the Court ruled as follows:

"More particularly, clauses 1.1.24 and 1.1.29 which outline the manner in which

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the proportionate share is calculated and which Vogel must assume in order to cover the operating costs, are perfectly clear and free of ambiguity.

Not only does the evidence reveal that such clauses are standard and usual when someone leases commercial space within a shopping centre, but the expert, Egan has testified to the effect that shopping centre tenants are perfectly aware of all their aspects and impacts." [Translation]

Furthermore, the Court recognized that the fact that the previous owner did not apply such a clause could not constitute a conclusive element. Therefore, the precise drafting of such a clause is essential to obtain the required results and its application being the norm in the industry, the Court recognized its validity without hesitation.

These examples therefore demonstrate the undeniable importance, which I cannot sufficiently stress, of the proper drafting of the lease and of an equal understanding by all parties involved. If the devil is in the details, paradise is, without any doubt, in a well drafted contract. •