

How Tenants Lose Money On Vacant Space

Although not a routine occurrence, some tenants for whom I have performed lease audits have downsized their space needs or completely vacated sizable amounts of leased space while still continuing to pay rent simply because the lease expires at a future date. **In these situations landlords will continue to bill a tenant for some operating expenses associated with services that the tenant is not receiving and for which the landlord is not actually incurring an expense.** Now that's one heck of a profit margin!

How does this occur and what can a tenant do to protect itself from not having this happen to it? This occurs when expenses that vary with occupancy levels are "grossed-up" to reflect a 95% or 100% occupancy level when building occupancy levels are less than these percentages. Virtually all commercial real estate leases provide for "grossing-up" expenses that vary with building occupancy levels. Examples of the most common expenses which are "grossed-up" include: cleaning contract, cleaning supplies, trash removal, water & sewer and electricity costs. When the "gross-up" principle is applied properly it is fair to both the landlord and for **any tenant which actually occupies space.** However, when the landlord bills a tenant for a variable expense for space which is vacant the landlord is making a profit at the expense of the tenant. This concept applies to both gross and net leases. **The analysis below illustrates this concept.**

Few tenants think about this concept at the time of the lease negotiation and thus the landlord is not obligated by the lease to exempt the tenant from paying for these variable expenses on the vacated space. With proper lease language, the tenant can be protected against paying for these expenses by including the lease provision below.

"Operating expenses shall not include any expenses that vary with occupancy and that Landlord does not incur because it does not provide the service with respect to all or a portion of Tenant's leased premises due to the non-occupancy of all or a portion of such leased premises. Specific expenses include, but are not limited to cleaning contract, cleaning supplies, trash removal, water & sewer and electricity costs."

If the lease is a gross lease then the following sentence should be added: *"Notwithstanding the previous two sentences this clause does not limit Landlord's ability to receive Tenant's share of any increase in expenses over the base year amount, but only for such expenses which Tenant is actually receiving and Landlord is actually paying for."*

The building contains 100,000 rsf.
 Tenant A leases 60,000 rsf and occupies all of its space.
 Tenant B leases 40,000 rsf and did not occupy its space.
 The cost of cleaning tenant spaces in the building is \$1/rsf
 Both leases provide for the expenses to be grossed up to 100% occupancy levels.

Actual cleaning cost paid by landlord @ \$1/rsf	60,000		
Gross-up adjustment	40,000		
Total cleaning expense for year	100,000		
		<u>Tenant A</u>	<u>Tenant B</u>
			<u>Total</u>
Total cleaning expense	100,000	100,000	
Tenant's pro-rata share	60%	40%	
Amount due from tenant	60,000	40,000	100,000
Amount paid by owner for cleaning	60,000	-	60,000
Excess amount received by owner	-	40,000	40,000