NET LEASES, BASE YEARS AND EXPENSE STOPS

By Mark D. Shapiro, Hyland Levin LLP APRIL 18, 2014

What do these terms mean and how do they work in practice? We often hear the terms net lease and triple net lease, which mean different things to different people. Typically, a net lease is where the tenant pays some of the operating costs of the property, and a triple net lease is where the tenant pays all of the operating costs of the property or its proportionate share of those costs. A net lease is designed to place risk of ownership, including the risk of increased operating costs, on the tenant. Operating costs include taxes, insurance and maintenance. Careful consideration should be given to defining operating costs in the lease. There are usually a laundry list of including and excluded categories of costs. Under a net lease, the tenant pays a base rent amount, plus the stated operating expenses incurred by the property.

In contrast, a gross lease is where the rent payable by the tenant is inclusive of all expenses and services provided by the landlord. This form of lease places the risk of increased operating expenses on the landlord. Tenants under gross leases are not incentivized to assist in controlling operating expenses, like electricity costs.

There are all sorts of variations on net leases and gross leases. Some are called modified gross leases or modified net leases. These modified forms of leases include either a designated base year, or an expense stop concept. In multi-tenanted properties, a landlord may designate a base year, which is typically the year prior to the first year of the lease term. The tenant will be required to pay its proportionate share of all operating expenses, but only to the extent that the annual operating expenses for the subject lease year exceed the annual operating expenses of the base year. The portion of the operating costs of the base year that are passed-through to the tenant are sometimes referred to as recaptured expenses. A careful tenant will confirm that the operating base year expenses represented by the landlord are in fact the customary and standard operating expenses for the building. Another variation is a "full service" lease, which usually covers expenses, including utilities and janitorial costs, with a base year concept.

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A less common modification to a net lease is an expense stop where the tenant is responsible for its proportionate share of the operating expenses, but only to the extent that the operating expenses for the subject lease year exceed the stated expense stop amounts. The expense stop method is useful where the leased premises is located in a new building, without prior operating cost history. For example, an expense stop lease might state that the rent is $20/square foot with all expenses to be absorbed by the landlord up to $7/square foot. Tenant, under that scenario, would be responsible for its proportionate share of all operating expenses above the expense stop of $7/square foot.

The key for operating expenses in leases is to carefully review the specific language of the lease and to not assume the terms based on a letter of intent or offer sheet that simply reads "triple net" lease.

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