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The Trend Towards Modified Gross Leases and Their Unpredictable Expense Structure

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There are three main types of leases for commercial and industrial property: (1) gross lease; (2) modified gross lease; and (3) triple net lease. A gross lease is somewhat unusual in the commercial and industrial lease industry. However, in this post-covid world, when negotiating an extension of a lease or possible renewal, we are finding that many landlords with a gross lease are taking the opportunity to revisit business terms and modify the existing payment and expense structure.

There is a noticeable trend in altering a gross lease to a modified gross lease, and the reason for this trend is largely due to the landlord wanting to shift the exposure of the cost of repairs or replacements to the building or common area to the tenant. A gross lease has a structure that obligates the tenant to make one total (a “gross”) payment of rent each month and the landlord takes the risk that they have calculated sufficient amounts in that “gross” rent to cover a sufficient return on investment, as well as repairs and replacement expenses to the building or common area. A pure triple net lease (often notated as a “NNN lease”) requires the tenant to pay its pro-rata share of all expenses related to the building and common area, which would include property taxes, insurance, utilities, and maintenance of the same, in addition to the base rent (base rent being landlord’s return on investment). A modified gross lease falls in between the two.

In a modified gross lease, the tenant is responsible for base rent (which would be the only obligation if the lease were still a gross lease) plus a variation of expenses for taxes, insurance, and common area maintenance for the entire building and common area. It is possible that a Landlord could be responsible for at least one or more of those expenses. The additional expenses are split between tenant and landlord, and the allotment of expenses is subject to negotiation. Typically, the expense structure is based on a price-per-square foot (i.e. calculated the same way as base rent). The types of expenses may vary from each modified gross lease, which makes it different from a pure triple net lease. Landlords intending to modify the existing payment and expense structure from a gross lease to a modified gross lease expect tenants to absorb largely unpredictable expenses. There are limitations that can be negotiated into a modified gross lease to counter the unpredictable expenses, such as an expense cap or defining a base year where tenant only pays expenses that exceed the base year. Every tenant facing a modified gross lease needs to be mindful of the additional financial obligations and understand what their responsibilities.

There are many other aspects of altering any lease to a modified gross lease that are worth discussing. Thus, we recommend consulting us regarding any type of modifications, amendments, or addendums that change the payment and expense structure of an existing lease. Please contact Mitchell Pollard or a member of the Real Estate Practice Group with any questions.