Retail & Office In Mixed Use Buildings–

The Devil's In the Differences

by Rick Burke, Lease Administration Solutions, LLC

The concept of mixed use buildings has been around for decades. Urban buildings dating back to the 1900s had businesses on the first floor and residential or manufacturing on the upper floors. Beginning in the 1950s, decay of inner cities and the creation of the mall ended most mixed use projects. Today there is a resurgence of mixed use developments as a result of urban renewal, renovated historical buildings and lifestyle shopping centers.

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Landlords are attracted to mixed use because of its potential to increase the building's rental income and appreciation while diversifying their portfolio.

Retailers have discovered a new customer base as Boomers sell their homes and move to mixed use condominium living. Customers enjoy the convenience of one stop shopping without having to drive several miles to the mall.

However, there is a disadvantage, which is the allocation of occupancy cost among the tenants. Unique building configurations and different tenant lease requirements challenge even the most experienced landlords when trying to allocate occupancy cost fairly in a mixed use building. Many of the overcharges found in lease audits are a result of the differences between retail and office lease language or industry practice.

For example, **Leased Space** configuration is a basic difference between an office and a retail lease. Retail space is mostly horizontal and is made up of expansions that are contiguous and coterminous to the original space. Retail space is based on leasable or occupied square footage and excludes lobby and common area.

In contrast, office space is vertical and can have several individual non-contiguous suites that roll up into the total square footage for any one lease. These suites may be non-coterminous and have different occupancy cost exclusions, base years, and rights. Office space may be stated as rentable square footage and include common areas and lobbies. Complexity of allocating cost to multiple office suites can often result in overcharges for both the office and retail tenants.

Pass-Through Cost for a retail lease consists of common area maintenance (CAM), real estate taxes, insurance and other miscellaneous costs. Retailers call common area maintenance "CAM" while office tenants refer to it as "operating expense or escalations." Retail tenants often pay their own utilities, cleaning and HVAC maintenance directly to the vendor. However, due to the uniqueness of a mixed use building, these expenses are often paid directly to the landlord. To avoid double payment, the tenant must verify whether a credit for these payments was taken against the CAM statement.

Office lease pass-through costs consist of operating expenses, real estate taxes, and insurance. Office tenants usually pay more in overtime electricity usage, which could end up as a double payment if not credited against the operating statement. Office tenants often pay for parking on a per space basis. These tenants must verify that there are no additional parking expenses such as insurance, cleaning, R&M or real estate taxes on the operating statement to avoid double payment.

The Base Year is a key difference between retail and office leases. Most retail leases are triple net, with utilities, real estate taxes and insurance paid separately from rent. Retail tenants pay 100 percent of their pro-rata share of these expenses for any stated period. Other types of retail leases are tied to CPI, capped, or have a stated fixed CAM amount.

Office tenant leases are mostly gross or full service with a base amount. The base amount is established from the operating expenses and/or real estate taxes for the first year of the lease, renewal option, or expansion term. The concept of the base amount is that the operating cost and/or real estate taxes are included in the calculation of base rent, and the tenant pays only its share of the amount above the base amount in subsequent years. Because it is in the landlord's best interest to have a low base year, the tenant should audit the base year early in the lease term. Office tenants also use stops, CPI and Porter's Wages. Porter's Wages are the union wages set for cleaning workers in the New York Area.

The Gross-up or extrapolation method is unique to office leases. If stated in the lease, the landlord can gross-up or extrapolate operating expenses to a stated percentage occupancy level in the building. The gross-up clause kicks in when the building is not fully occupied. This is common in new buildings. Suppose the lease allows the landlord to gross up to a stated 95 percent occupancy level, and the current occupancy level of the building is less. The landlord would then be allowed to increase the operating expenses as if the building were occupied at the 95 percent level. However, not every operating expense account is "grossed up." Only variable expenses that change with the level of occupancy should be adjusted.

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In a mixed use building, understanding the differences between retail and office leases can help the tenant determine the most effective review approach. Ultimately, it is the tenant's responsibility, not the landlord's, to make sure the billing is correct. The best way to ensure this is to better understand the total cost of the building