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Reevaluating REAs

Part Two of a Three-Part Article

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Reciprocal Easement Agreements (REAs) among one or more developers, department stores, and, in the mixed-use context, owners of parcels devoted to non-retail uses, have rarely been formulaic. Part one of this three-part article discussed how the economy has impacted the flexibility and control of REAs, nontraditional occupants, consolidation and conveyance of improvements. Part Two herein focuses on operating covenants and monetization of real estate.

OPERATING COVENANTS BY DEPARTMENT STORES AND INDUCEMENTS

BY DEVELOPERS

Operating Covenants

Department stores are virtually the only anchors that still provide long-term operating covenants. To some extent, this is understandable. A department store has usually been considered more vital to the success of a project than, say, a home improvement store in a power center. Developers have traditionally refrained from committing substantial dollars to a regional mall until the minimum number of department stores the developer deems necessary for the viability of the project have been signed up. According to Bob Beffa, a Dallas-based senior vice president of real estate for Macerich, department-store operating covenants remain valuable for financing and small-tenant leasing, provide justification for the major investment a developer makes (including purchasing the land and going through the entitlement process), and should not be a difficult concession for a department store that has decided to commit to the project and construct its store. But, is a department store that is not one of the highly sought-after brands more vital in a large mixed use project than, say, a Target, a hotel or a large office building in that same project?

To my knowledge, Target has so far refrained on a national basis from giving operating covenants (or even opening covenants). If Target and traditional department stores appear in the same projects more frequently, how will this discrepancy be resolved? It is certainly possible that traditional department stores would refuse

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to agree to be the sole provider of operating covenants in the future, especially when department stores may now be more “downside” oriented and less confident in the developer’s predictions for success. Department stores are typically not concerned about the right to enforce other department store operating covenants. (In fact, each department store may insist that its operating covenant only be enforceable by the developer and its successors and lenders.) However, a department store may not be interested in making a legally binding long-term commitment to a project if other anchors are not providing such a long-term commitment because there is less assurance that the project will in fact be developed and sustained. If department store operating covenants disappear or are substantially watered down, will debt and equity providers be less willing to fund development projects?

Recapture provisions triggered not only by going dark, but by a change from department store use may mitigate (though not solve) the problem created by the lack of an operating covenant. However, recapture provisions are only useful to the developer if the acquisition price is workable. Unamortized book value calculations are usually acceptable, but fair market value calculations often required by department stores can create problems for the developer, including problems relating to predictability and the need for the developer to respond quickly to salvage the project (since fair market value calculations are often subject to dispute). If the department store has a mortgage or deed of trust on its store, what happens if the outstanding amount of the loan to be paid off at the time of the convey-

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ance exceeds the recapture price otherwise provided for (and what happens if the loan is a blanket loan that may not include release prices for each store)?

David Huprich, a principal of Reveal Real Estate Advisors, LLC, near Cincinnati, OH, suggests that developers should increase their demands for recapture rights if the department store does not construct or if the operating covenant is no longer enforceable — at a price close to unamortized book value — because the department store is in effect saying that the location is not worth much anymore.

Monetary Inducements

Developers sometimes “buy” a department store’s (especially a sought-after department store’s) commitment to a project by offering not only free land and site work, but also a substantial inducement payment, sometimes structured as a construction contribution but more frequently structured as a contribution to capital of the department store company. (My tax colleagues tell me that the developer presumably can amortize or depreciate such capital contribution payment, but that there is little authority on which to rely.) As such payments reach \$20-\$30 million, do they really work for either party? Having been recently burned by stalled projects, will department stores consider the #2 site in lieu of the #1 site by reason of such payment, given that their own commitment in construction costs, merchandising costs, labor costs and, perhaps most importantly, reputation, far exceeds the inducement payment? Mr. Huprich observes that as projects begin to be developed, it is likely that the department stores will know that they need to go to the #1 site, but may nevertheless ask that developer for “pot sweeteners.”

Will department stores refuse to provide operating covenants without large inducement payments, and will developers continue to pay extraordinary amounts to lure a department store to its project when the operating covenants are full of large holes? Conditions to operating

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covenants relating to the operation of a percentage of small tenants are difficult for the developer to satisfy in a difficult economy (that is, exactly when the operating covenants are most important), and conditions to operating covenants relating to the operation of other department stores are difficult for the developer to satisfy, not only because of the economy, but also because of department store consolidation (described in Part One of this article). The assumption that the department stores will, in fact, anchor the project in stormy seas may sometimes be illusory, even in the context of an operating covenant. On the other hand, if the developer is able to satisfy the conditions, an operating covenant may be sufficient to prevent a department store from jumping ship in favor of an even higher inducement paid by the developer of a nearby project, especially since courts, although often loathe to specifically enforce operating covenants, are sometimes prepared to award significant damages. Potential damages include diminution in value of the project, lost rent from the developer's tenants in the project (especially in the context of co-tenancy provisions), liquidated damages (if provided for in the agreement with the department store), and a department store tenant's percentage rent (if the department store had previously been producing sufficient sales to generate percentage rent pursuant to a percentage rent clause in its lease).

Damages for Late Delivery

The economy has caused many developers to postpone projects (sometimes before commencement, sometimes in the process of construction, and sometimes after one of several planned phases has been completed and opened). Should damage provisions in REAs and leases with department stores be drafted so that damages payable by the developer can be mitigated if the department store is given sufficient notice of a project commencement delay (or decision not to build) so

that the department store can avoid paying substantial costs to third parties? Should department stores be given similar flexibility if their expansion program is curtailed? Should the answer be different if the department store instead decides to move its proposed store to a competitor's project? Per-diem damage provisions can be difficult to draft, since department stores are often concerned about delays not only in the developer's opening date, but also in a number of milestone dates along the way (because the milestone dates are related to commitments by the department stores to third parties). But if failure to satisfy each milestone date triggers per-diem damages, avoiding duplication of damages is not easy. On the other hand, general damage provisions can be unsatisfactory to each side, since the department store will have to overcome a difficult burden of proof, and the developer will be at risk for substantial consequential damages, e.g., lost profits of the department store.

MONETIZATION OF REAL ESTATE IN AN OPERATING PROJECT

It is not often possible to ascribe motives in the event of a department store's request for monetary or other consideration to approve a change in the project. Requiring a reasonability standard for approval or, better from the developer's perspective, a requirement that approval be given unless in the department store's reasonable judgment the requested change is likely to have material and adverse impacts on the department store's operations, can be useful but only goes so far. The issue, of course, cuts both ways since the developer is often on a quest to maximize revenue from its project (without necessarily limiting such revenue sources to rent paid by tenants).

Mr. Beffa suggests that it is a mistake to let the document get in the way of success of a project. He urges business people on both sides to make decisions based on what will "enhance value and add to the business," and further urges them to "seek common ground where interests are aligned and find opportunities for creative compromise

and relationship building" instead of "mere spreadsheet analysis." He points out that those in the department store business who have the luxury of taking a long-term perspective understand that the department store and its parcel are part of the overall project, and if a change is made that makes the project more successful, the department store is likely to reap benefits from the change — that the project should be "part of the department store's business, not just a place where it does its business." He suggests the nature of the department store's request is significant — comparing, for example, a department store's request for assistance in updating its interior or façade to respond to a developer's proposed project reconfiguration with a requirement that money be paid for an approval of a mutually beneficial internal roadway reconfiguration.

A few additional examples of potential monetization are set forth below. I think they are all worth discussing to determine if REA provisions should be changed.

Sale or Ground Lease of a Portion of a Party's Parcel For Retail (or Other) Use

Either the developer or a department store may wish to convert some of its parking field to income. There may be no choice but to negotiate this issue when it arises, taking into account at such time all relevant factors, including adequacy of parking after the change and any impact on access of the change. However, a party that contemplates the likelihood of such a transaction might also ensure that the permissible building areas shown on the site plan are as flexible as possible and that the required parking ratio is as low as possible. The developer might also endeavor to provide for a parking ratio that relates to all of its parcels in the aggregate, rather than one calculated on a parcel by parcel basis so it can reduce the density of one parcel as it seeks to increase the density of another parcel. In such an event, the developer will need to allocate the obligation

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carefully to comply with ratios if it conveys one of its parcels to a third party. (Of course, if the developer is able to provide substantial details of the planned change to the parking field, it might even be able to obtain advance approval when the REA is being negotiated.)

Income from Signage

Some REAs provide that signs within the project may only include the name of the project and the names of the occupants of the project. Signage, including digital signage and future iterations thereof, advertising off-site entities can be a substantial source of income, as evidenced from the substantial revenue obtained by selling billboards on top of buildings in the entertainment areas of Los An-

geles. Should that potential income source be precluded and, if permitted, should all of the income belong to the developer?

Income from Leasing or Licensing Portions of the Mall or Exterior Common Area

Kiosks and other Retail Merchandising Units (RMUs) offer traditional income sources that department stores customarily acknowledge, subject to restrictions based on appearance, size and lack of interference with access. Marketing possibilities for common areas are expanding. Should there be a credit of some portion of such income against CAM? Should such a credit be inapplicable if the department stores have (as they usually do) a special CAM deal?

Income from Parking Structures

Charging the public for parking was absolutely prohibited in many

of the early REAs and is subject to substantial constraints or approval processes today. Department stores are loathe to restrict parking by their customers in any way. They now recognize, however, that various schemes for charging for parking (for example, charges after a free or validated initial parking period) can inhibit "poaching" by non-retail parkers and over-use by retail parkers who may conduct additional business off-site. Should this income be shared in some way (taking into account the capital contribution made by the developer to construction of the parking structure and taking into account its costs of operation)?

CONCLUSION

Part Three of this article will cover parking, site plan and use restrictions.

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