

Recapture Of An Anchor Store: Satisfactory Compromise Or Illusory Right?

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Anchor tenants inevitably seek flexible exit strategies. In today's market, their hot button positions may be absolute deal points. These positions may include an unwillingness to commit to construct, open or operate and the right to assign and sublet with relative freedom. Some anchors are more concerned about operating covenants than construction and opening covenants, and traditional department stores may provide (highly contingent) operating covenants, but a developer's comfort level that it will retain its anchors appears to be diminishing just as the adverse consequences are increasing. As non anchor tenants increasingly insist on co-tenancy requirements, the risk of a melt down becomes more than theoretical.

One standard compromise has been the recapture right. If the anchor fails to construct, open or operate or seeks to assign or sublet, the developer is granted the right to recapture the anchor store and seek to provide a replacement anchor (or, perhaps more likely, another satisfactory retail or non retail alternative).

The recapture right can be negotiated with both an anchor that has leased its premises and an anchor that has purchased a parcel in the project. (For this reason, references in this article to recapturing an anchor store will mean, alternatively, termination of a lease or acquisition of the fee owned parcel and, each case, acquisition of the store building.)

The problem is that there are complex issues that, if not successfully resolved, can eliminate many of the perceived benefits of recapture rights. The issues include: (1) what triggers the recapture right and can the timing requirements of the important players be reconciled? (2) what price must be paid to consummate the recapture? and (3) is recapture even feasible given the requirements of the anchor's lender (or potential lender) and the developer's lender (or potential lender)?

TRIGGERING ISSUES

Failure to construct: The issues that arise in connection with recapturing a partially completed store can be mind boggling. For example: (1) what happens to the anchor's contractor and the construction contract? (2) what store ultimately gets constructed if the intent is to find a replacement, and (3) to what extent does the partially completed (but perhaps useless) construction work get reimbursed? A more satisfactory approach might be to have the recapture trigger be the failure of the anchor to commence by an agreed upon date (subject to extension by force majeure and any failure by the developer to perform its obligations). The anchor would need to be willing to commit to complete construction diligently (preferably within a specified period from the developer's perspective) once it has actually commenced construction. The anchor's financial condition would dictate whether security for completion should be sought.

Failure to open: Some anchors may be willing to commit to open for one day if they are willing to commit to construct, even if they are not willing to give an operating covenant. A critical question is whether they are willing to commit to open under a specified name.

Failure to operate: Will the anchor be deemed to be operating if it is operating under a different name (pursuant to an assignment or otherwise), if the use has changed or if it is only operating in a portion of the store building?

Assignment/subletting: Is the recapture right triggered by some undefined intention to transfer (without necessarily identifying a transferee), the execution of a letter of intent, or the execution of the assignment/sublease documentation? The anchor might prefer the earliest possible trigger date so it knows the developer's position prior to marketing its space (since neither brokers nor potential transferees



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may be motivated to commit in the face of being undercut—or may require a break-up fee). The developer might prefer a later date so it will know the identity of the proposed transferee and its contemplated opening date before making a recapture decision.

Timing and other considerations: Recapture will likely be dependent on the developer's performance of its construction/operation obligations and perhaps satisfaction of co-tenancy conditions of the anchor (including operation by specified other anchors and a percentage of smaller tenants). Such construction and operation conditions will likely be subject to the same economic forces that are causing problems for the anchor and may therefore be difficult to satisfy. Force majeure will likely be an excuse, and the force majeure definitional issues can be daunting, particularly in a significant recessionary climate. Will the developer be required to exercise its recapture rights only within a limited window period after the triggering event has occurred and, if so, will it be able to analyze the issues and obtain all necessary approvals from its

joint venture partners and lenders within the required time frame? If the developer fails to exercise its recapture rights (perhaps because it is comfortable with the replacement proposed by the anchor), does the recapture right disappear or can it be exercised in the event a future trigger event arises?

PRICING ISSUES

The amount payable to an anchor whose premises are being recaptured can be difficult to negotiate and, if the recapture is triggered, subject to dispute. In a build to suit lease situation, the landlord may successfully argue that no amount should be paid to the anchor. In any other lease situation, and if a fee interest is being recaptured, the anchor will almost inevitably require payment. The most likely formulations are a cost reimbursement or a fair market value reimbursement (and anchors often seek to obtain the greater of the two).

Cost reimbursement: Typically, only the portion of the construction costs that have not yet been amortized are payable. Issues arise as to (a) whether assets other than construction costs on the anchor's books for this asset are payable (for example, good will or similar categories of assets reflecting an increase in value attributable to purchase or corporate restructuring after initial construction), (b) the length of the amortization period (including whether it is different for elements of the building with different useful lives and how it relates to the term of the lease or any unexercised options), and (c) whether subsequent alteration costs are included (and their applicable amortization periods).

In any event, personal property should be excluded and tenant improvement allowances or build out costs incurred by the developer for the anchor should be excluded. If the compromise (relating to use of commencement as a trigger) described above is agreed upon, the pricing issues are minimized. Some anchors may be willing to accept as reimbursement only the purchase price it paid the developer in a purchase situation, and no consideration at all in a lease situation.

Fair market value reimbursement: Value can be in eye of the beholder party (and its appraiser), especially if instructions are not clearly set forth in the lease or other

document providing for the recapture. The process for selection of an appraiser or appraisers can be complicated and the process for determining value can be time consuming. Do the unique circumstances surrounding the conveyance (cessation of operation, for example) make choice of comparables difficult? Are the benefits and burdens of the lease itself to be taken into account? Pricing disputes can substantially lengthen the recapture process and thereby negatively impact the developer's ability to court a replacement anchor and get that replacement anchor (who may not be willing to commit resources pending resolution of a dispute with the closing anchor) up and running.

FINANCING ISSUES

Financing issues relating to an anchor's lender: Financing issues can become recapture pricing issues. An anchor that contemplates the possibility of financing its fee or leasehold interest will endeavor to avoid having the recapture provision impact such financing or the amount that can be financed. It may insist that the amount payable to recapture the store be increased to the extent necessary to pay off the outstanding balance of any financing secured by the store. Does this include prepayment fees or defeasance costs? How are blanket loans dealt with? What if there is a lock out period in the loan documents? If the developer is ultimately not willing to pay more for the asset than its value, it can of course avoid exercising the recapture option, but then the perceived value of the recapture right may be illusory.

The recapture provisions should also specify to what extent they affect, or are affected by, a foreclosure of an anchor's loan prior to the occurrence of any recapture. Is the foreclosure unaffected by the recapture provisions, and are the recapture provisions of no further force or effect? A compromise that has proven acceptable to lenders in the past is that although recapture provisions do not affect the foreclosure (or a deed in lieu), they spring back into effect after the foreclosure, but only after the anchor's property is owned by an entity other than the lender or its affiliates. However, the anchor may be hesitant to agree to this compromise in today's financing market because of its potential negative impact on its ability to

obtain financing.

Financing issues relating to the developer's lender: The developer's loan documents are likely to require the lender's consent to recapture an anchor's leased premises. Will the lender agree to a reasonability standard in today's financing market? Is it likely to grant such consent if a replacement anchor has not been located (and how locked in must that replacement anchor be)? Will the developer's loan documents also require the lender's consent to recapture the store of an anchor that purchased fee title to the property from the developer even though that property is not encumbered by the loan? Will the result be less favorable if the loan documents provide that (a) the security includes "after acquired" property, or (b) the single purpose entity borrower is not permitted to own property other than the property encumbered by the loan? If so, one potential solution might be to have the adjacent fee property purchased by an affiliate of the developer, and this right should be included in the recapture provision.

FINAL THOUGHTS

The mine fields described above can be avoided only by careful negotiations and drafting. Even if the recapture provisions are successfully negotiated and a recapture is successfully pursued, the developer will (1) be releasing the anchor from future liability (if the anchor is a tenant), (2) be required to pay broker's fees and a tenant improvement allowance or construction costs for the replacement, and (3) need to make sure that the replacement (and the alterations required for the replacement) will satisfy tenants with co-tenancy rights and alteration approval rights, lenders and joint venture partners. However, the developer may not know the identity of the replacement when it is required to pull the trigger on the recapture. **SCB**

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