Phased Development of Retail Projects: Part 1 - Site Work and Cam Costs

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Developing real estate for commercial retail projects is a complex undertaking even in the simplest of circumstances. To successfully develop a retail project in phases, a developer must also consider the impact of phasing on construction and payment obligations and otherwise reconcile the development parties' competing interests.

Why Develop in Phases?

Phasing occurs for a variety of reasons, typically when conditions for the whole development of the project are incomplete. For example, the developer may not (yet) own all of the land required for the entire development, may have obtained entitlements for only a portion of the property or may believe that the maturity of the local market will not support an immediate full build-out without risking leasing and related economic difficulties.

Often, anchors may determine the phasing of a development. If a developer has a deal with an anchor (but no other retailers) that provides sufficient funds only for the developer to purchase the land, a developer that is optimistic about the location's future may perform limited site work on a speculative basis, without performing additional site work until it has sold additional parcels.

Phased development also permits the developer to postpone other legal or financial obligations. For example, a developer may await the complete remediation of contaminated land before purchasing it or may delay the development of a project to an extent that might trigger expensive off-site work required by governmental entitlements. Allocation of Site Work Costs and Obligations

To best manage costs, a developer typically performs only the site work required for each phase, as it is constructed. Also, the developer may elect to perform additional work because costs would increase if it delayed performance to a later phase, or physical and other practical considerations dictate a more complete build-out. Developing a project in phases often increases construction costs per foot for many reasons, including the effect of inflation and of changes in regulatory, insurance or financing requirements, unavailability of the original contractor (or subcontractors) at later dates, less-competitive contractor bids for smaller projects, systems coordination and the effect on warranties, and unavailability of efficiencies in grading. Uncertainties as to pricing of future phases increase the risk of phasing the work. Governmental or anchor requirements also affect the scope of initial development. Timing can affect entitlement negotiations (e.g., postponing installation of a traffic signal until construction of a minimum floor area amount). An anchor may buy a parcel and construct its building without assurance that future phases will be developed, as long as the developer performs certain "off-site" work that is either outside the entire project (e.g., street widening) or within the project but outside its parcel (e.g., internal roadways).

The factual situation often determines the developer/retailer allocation of performance obligations, including: type of transfer (lease or sale), the parties' relative financial resources, the retailer's store size and future expansion plans, the scope of the site work, the extent to which site work must serve other retailers in that phase, and the likelihood of developing future phases. The costs of the developer's on-site work (especially if limited to grading and utilities) is frequently fixed or included in the purchase price in a sale transaction. Off-site work costs might also be fixed but, since they are harder to estimate (especially if governmental requirements are not finally determined), these costs are more likely to be allocated in accordance with a percentage sharing formula, perhaps subject to a "cap." Issues arise as
to (i) the exclusion of costs from the shared costs, (ii) the time and manner of payment for future site work and (iii) the manner in which the percentage is calculated.

- Exclusions from Shared Costs: One common category of exclusions is project ownership costs, as distinguished from site work costs. For example, interim financing charges, taxes and insurance might be excluded. Another category is entitlement costs, as distinguished from site work required by the entitlements; for example, costs of attorneys, traffic consultants and land use consultants. More difficult to resolve are the costs of consultants (e.g., fees for architects, engineers, surveyors, soils and environmental consultants) whose plans, investigations and reports were required to obtain the entitlements but are also inextricably tied to the site work.

- Payment for Future Work: An example is a freeway interchange benefiting the entire project, which is required by the entitlements only upon construction of a threshold amount of the floor area. It is difficult for the developer to seek reimbursement only from owners of buildings constructed after the threshold is reached, but determining the time and manner of reimbursement from earlier parcel buyers requires careful negotiation. Alternatives for the manner of collecting the payments include (1) a fixed amount at closing, (2) an estimated amount at closing, subject to reconciliation upon project completion when costs are known, (3) periodic amounts after closing as costs (including architectural and engineering costs) are incurred, and (4) one lump sum upon project completion when costs are known. If completion is scheduled to occur several years after closing, the developer may require a letter of credit or other security for the payment or performance obligation. Existing retailers, more frequently favoring exit strategies than long-term commitments, may have difficulties with this issue.

- Negotiating the cost of off-site work performed during a later phase is difficult if it is unclear how parcels in previously developed phases will benefit. Examples are curb cuts and roadways not proximate to buildings developed in the earlier phase, but which are likely to be used occasionally by their customers. The earlier phase owners will be reluctant to participate in the costs, even if only billed upon completion of construction, because of the uncertain benefit and because of their need to budget capital expenditures when they purchase the land. If the site work is instead constructed in advance (to avoid budgeting problems), the developer may be in an even worse position because the purchasers of the later (clearly benefited) phase might also be reluctant to pay because the improvements are already in place and (arguably) part of the purchase price. Ideally, the developer should segregate the phases to perform each phase’s site work only when it is developed and charge costs only to the owners within that phase; however, cost factors and entitlement terms may hamper the feasibility of this approach.

- Calculation of Cost Sharing Percentage: Two issues often arise: (1) is the percentage based on the land area or floor area, and (2) to what extent does the cost sharing percentage include future phases? If the land area/floor area distinction matters (i.e., if some parcels’ land area is not proportionate to building size, or if all projected floor area has not yet been constructed), then the developer should determine if it is worth the complexity to provide that work costs more closely associated with the land area (e.g., storm sewer facilities, grading) are allocated by the land area, and that work costs more closely associated with usage (e.g., traffic signals, other street improvements) are allocated by the floor area. If the developer includes future phases in a land area calculation, it will then be responsible for bearing the share for future phases before their development and sale; on the other hand, the early phase parcel owner does not want to pay for site work to the extent it benefits other property. Again the solution is to perform site work benefiting a phase only when the phase is developed. Where municipalities construct off-site work that is financed through local improvement charges (amortized over the period of the municipality’s long term borrowing), provide for anchor prepayment rights in the development agreement and the borrowing by-law, negotiate with the municipality a fair allocation of the costs to the site and to neighboring sites that the work benefits, monitor the municipality’s costs to minimize exposure, monitor the
borrowing by-law process, and cap the amount the municipality can borrow.

To document site work obligations, some anchors use an integrated purchase, sale and development agreement, which usefully locates all of the “up front” obligations in one document. On the other hand, it is likely that certain pre-closing developer obligations (not usually included in a separate development agreement) will survive closing. Anchors often request that a memorandum of the site development agreement (whether or not a separate document) be recorded against the remainder of the developer's property in the project, but future purchasers and lenders may object when they discover this title exception. The problem is exacerbated if the anchor has the right to file a lien against the developer's property upon developer's failure to perform its site work obligations. Therefore, it is important to provide a release procedure as parcels are sold, which is easier to negotiate if the developer (not the parcel purchaser) is responsible for the site work to be performed on the parcel being sold and if the developer still owns a substantial amount of land in the project.

Sharing Common Area Maintenance (CAM) Costs

A Reciprocal Easement Agreement (REA) (or a lease, if the property is leased rather than sold) usually addresses CAM cost sharing issues. Primary issues are similar to those noted above with respect to calculating the site work cost sharing percentage. Most CAM costs are closely related to usage, so a floor area calculation is most common. However, a pure floor area approach frequently does not satisfy an anchor because undeveloped parcels bear no share of CAM costs; the anchor prefers to include all buildings shown on the site plan, whether or not constructed. On the other hand, if the REA uses a land area approach (which achieves results like those in the previous sentence), the developer prefers to include only developed parcels. Here are a few compromises:

- **Denominator With a Floor:** For the percentage calculation, the denominator, which includes only completed buildings, is never less than a certain number (regardless of stage of development) that could increase over time.
- **Build Out Period:** The denominator includes all buildings shown on the site plan, excluding certain buildings (usually on out lots not intended for immediate development) for a certain number of years, unless construction of those buildings is actually completed.
- **Separate Maintenance:** Each owner would maintain its own parcel. This is sometimes the only solution if the developer cannot predict if and when future phases will be brought on line and is unwilling to assume any maintenance burden for undeveloped phases. It may also suit an anchor that requires services during extended hours (e.g., more frequent snow removal than typical retail requires). However, the quality of maintenance will likely vary with each owner, and inferior maintenance of even a portion of a project can impact the entire project. As a partial solution, the REA should include maintenance standards and cure provisions; the REA should also allow a developer/anchor group to impose a CAM cost sharing regime on the project at a later date without the consent of each parcel owner (so long as the initial REA sets forth the method of calculation). It should also allow any parcel owner group to develop a cost-sharing scheme for their own parcels (without amending the REA), so long as each owner remains responsible for the maintenance of its parcel. Finally, even if, in principle, the developer and each anchor maintain their own parcels, the REA should provide flexibility to work out cost-sharing arrangements as circumstances warrant.
- **Shared Maintenance of Only Specified Common Areas:** A variant on the separate maintenance approach is to provide a cost sharing scheme only for specified common areas, especially common areas that are not located solely on one parcel (like internal roadways and storm drainage retention areas). When considering only these limited areas, the developer and the anchors may be more likely to agree on the percentage.
Management and Control: Retail developments are usually designed to be integrated and seamless to the consumer, so that each may benefit from the anticipated synergies the respective retailers bring to one another. In the REA, all parcel owners should have the right, upon common standards, for maintenance, snow removal and other issues of common concern. How should the developer address self-help remedies among the retailers? The more frequently these rights are given, the greater chance for confusion. Realistically, if the developer is not performing, the retailer needs to react expeditiously before its customers go elsewhere. Notice periods and curative delays are generally negotiable, although snow removal in winter climates usually cannot wait. If site conditions permit, consider isolating the areas in which the anchor may exercise self-help to its parking lot and principal access routes.

Part Two of this Article. The second half of this article will address additional phased development issues such as site plan controls, use controls and exclusive uses.

Note: Substantial portions of this part 1 of this Article were taken from an article by Sheldon A. Halpern entitled "Phased Development", which appeared in "California Centers" Issue No. 40 at page 62.

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