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Peer to Peer 10

**Anchor's Away! What's an Owner to Do?
Repurposing Shopping Centers to Include Distribution Centers and Other Non-Traditional Uses**

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DESCRIPTION OF SESSION:

Faced with an ever-growing number of untenanted anchor locations, shopping center owners are increasingly considering whether to fill these vacancies with, or to redevelop their shopping centers to include, fulfillment and distribution centers for Amazon and similar online retailers, and other non-traditional retail and non-retail uses. While adapting shopping centers to a changing retail economy may be necessary for survival, the introduction of new, non-retail uses such as fulfillment centers, or other non-traditional uses may be hampered by (1) logistical concerns such as parking, loading and traffic flow, (2) incompatible covenants and agreements with existing tenants that require the preservation of traditional anchor store or retail uses, (3) neighborhood and community opposition, and (4) outdated zoning laws that would prohibit such uses. Finding creative and effective workarounds can add tremendous value, and can mean the difference between project success and failure. In this session, participants will consider hypotheticals and will strategize together to come up with ways to overcome impediments to the introduction of both a "last mile" distribution center, and "ghost kitchen" restaurants to a struggling, suburban shopping center.

FACT PATTERN 1:

Trophy Properties ("Landlord") owns a 60-year old suburban strip center that includes 40 retail bays, with a 50,000 square foot department store anchor location at each end (the "Center"). The Center is served by a surface parking lot with 1,400 parking spaces. Circuits-R-Us, a major big box electronics retailer, will close its doors next month due to bankruptcy after 40 years of continuous operation, leaving the Center with a vacant anchor location. Nearly half of the retail spaces have become vacant over the past two years. The anchor location at the opposite end of the Center has been leased to Bargain Value Mart ("BVM"), a discount department store chain, since 1975 pursuant to a 60-year lease. As the only remaining big box store of its kind in the area, and as the result of a growing e-commerce presence, BVM has continued to do well despite the declining use of the Center.

Last Mile Services ("LMS"), the nation's largest online e-commerce retailer, has approached Landlord with an offer to enter into a 25-year lease for the entire vacant anchor location for use as a warehouse and "last mile" fulfillment and distribution center. The size of the vacant space and the strategic location of the Center, less than a mile from the interstate, will enable LMS to expand its "same day delivery" guarantee to more than 200,000 LMS subscribers located within a 5-mile radius of the Center.

To accommodate LMS, significant infrastructure enhancements will be required at the Center. LMS will require the permanent removal of nearly 700 Center parking spaces at the Center to accommodate 5 new loading docks, a truck turn-around area, a delivery vehicle waiting area, and a future delivery-drone launching area. LMS anticipates that contracted delivery vehicles will make more than 1,000 trips per day to the LMS warehouse. 18-wheel trucks will make deliveries on a 24/7 basis, and LMS expects to operate its delivery service around the clock. Landlord does not perceive this to be a problem for the existing Center tenants because the parking lot is rarely more than 25% full.

With no viable retail bidders for the vacant anchor space, Landlord is seriously considering LMS's proposal, which includes a requirement that Landlord obtain county approval to rezone the Center from "Retail High Density" to "Retail/Industrial," as required for LMS to operate.

Landlord is concerned that BVM will object to LMS as a tenant in the Center, especially since, less than a year ago, Landlord refused BVM's request to convert 50% of its retail showroom area to warehouse-style storage in support of BVM's fast-growing "click and collect" and online purchase return center business. Certain terms of the BVM lease could be problematic. The co-tenancy provision in BVM's lease reads as follows:

In the event Circuits-R-Us, or one or more national sellers of retail goods or provider of other retail services is not open and operating within 50% or more of the 50,000 square foot anchor location at the opposite end of the Center, Tenant shall be entitled to abate Minimum Annual Rent until tenants meeting the foregoing requirements are again open and operating.

The parking requirement in BVM's lease provides as follows: "Landlord will ensure that no fewer than 1200 parking spaces will be provided at the Center, as required to service the retail operations operating within in the Center, as shown on the Plans attached as Exhibit A, from time to time."

DISCUSSION QUESTIONS:

1. Landlord needs this LMS deal, and has asked you to coordinate with Landlord's land use/zoning counsel to identify several compelling arguments as to why the Suburban County Planning Commission should approve the application to rezone the Center to "Retail/Industrial". What are the strongest arguments in favor of the conversion?
2. Landlord fears that the Neighborhood Civic Association, which represents nearly 10,000 residents living in high-rise buildings in the immediate vicinity of the Center, will strongly oppose the rezoning. In the past, the NCV has aggressively lobbied Landlord to preserve retail uses in the Center, as it is the only remaining retail service area within walking distance of its membership. What might several of their objections be to the introduction of LMS to the Center, and how might Landlord most effectively counter each of them?
3. Bargain Value Mart has preemptively contacted Landlord about the rumors that LMS may lease the vacant anchor location. Specifically, BVM claims that a lease to LMS would violate the co-tenancy requirement and minimum parking requirements in BVM's lease, entitling BVM to the abatement of rent. Are they correct? What is BVM really concerned about? How might Landlord counter these arguments and/or creatively resolve these issues with Bargain Value Mart?

FACT PATTERN 2

Assume all of the facts set forth in Fact Pattern 1.

Thai Garden is the sole remaining restaurant tenant at the Center. Having experienced a 60%-80% reduction in in-person dining during the pandemic, Thai Garden has fallen three months in arrears in its rent payments. A 50% increase in delivery and "contactless-pick-up" services for customers within a 5-mile radius of the Center has allowed Thai Garden to stay in business during the pandemic, and to keep most of its staff employed. Thai Garden now derives nearly 70% of its gross revenue from take-out and delivery services.

Over the past 6 months, Landlord has received proposals from 3 regional and national restaurant chains, including Bangkok Buffet, a national Thai restaurant chain featuring freshly made Thai food served at large buffet stations in most of its locations. These prospects are eager to lease vacant retail and restaurant space in the Center, ranging from 800 to 1,000 square feet to set up "ghost kitchen" operations, which are an online-ordering and delivery-only restaurant model. Eager to expand their customer base, and lured by the Center's proximity to 200,000 people in a five-mile radius, and by the lower rent rates Landlord can command in a struggling strip center, these ghost kitchen

operators see nothing but opportunity. Without a dine-in option, ghost kitchens will typically need only 500 to 1,000 square feet of space per kitchen and will save money without having to hire waitstaff.

Landlord is intrigued by these proposals, especially since ghost kitchens would appear to be very compatible with LMS, which also will draw no foot traffic to the Center. However, Landlord is concerned because the ghost kitchen operators want relatively short-term leases (3-5 years), very low rent, and they expect Landlord to shoulder most of the costs to convert the existing retail locations. They are also requiring exclusive use of dozens of prime parking spaces adjacent to the Center as a delivery vehicle waiting area.

Landlord is worried that leasing ghost kitchen space to a Thai restaurant chain may violate a tenant-exclusive provision in its Thai Garden lease. Sure enough, one week after Thai Garden learned about the potential addition of a Thai-themed ghost kitchen at the Center, Landlord received a certified letter from Thai Garden's counsel objecting to (a) Landlord's introduction of a competing Thai restaurant at the Center, in violation of a negotiated tenant-exclusive in the Thai Garden Lease, and (b) Landlord's plan to reserve parking lot spaces for ghost kitchen tenants. The pertinent provisions of the Thai Garden Lease provide as follows:

During the term, Shopping Center Owner will not lease any retail space within the Center to any competing national, regional or local full service Thai restaurants.

Shopping Center Owner covenants not to restrict any parking lot spaces serving the retail operations in the Shopping Center, with the intention that all such spaces shall be equally available to all retail patrons during opening hours.

DISCUSSION QUESTIONS:

1. Landlord is uncertain of the risks of leasing to a ghost kitchen operation and has come to you for advice. Given the uniqueness of the ghost kitchen use, what are five (5) areas of concern that Landlord should consider when preparing Bangkok Buffet's lease?
2. As Landlord's attorney, what are your best arguments to persuade Thai Garden's counsel that leasing ghost kitchen space to Bangkok Buffet and reserving delivery vehicle parking spaces would not violate the terms of Thai Garden's lease? What do you think Thai Garden is most concerned about?
3. Despite your best efforts, Thai Garden's counsel refuses to come around to your way of thinking. What might Landlord offer to Thai Garden in order to settle the matter and resolve Thai Garden's concerns? How might Landlord persuade Bangkok Buffet to back off of its reserved parking space requirement?

Anchor's Away! What's an Owner to Do?

Repurposing Shopping Centers to Include Distribution Centers and Other Non-Traditional Uses

Faced with an ever-growing number of untenanted anchor locations, shopping center owners are increasingly considering whether to fill these vacancies with, or to redevelop their shopping centers to include, fulfillment and distribution centers for Amazon and similar online retailers, and other non-traditional retail and non-retail uses. While adapting shopping centers to a changing retail economy may be necessary for survival, the introduction of new, non-retail uses such as fulfillment centers, or other non-traditional uses may be hampered by (1) logistical concerns such as parking, loading and traffic flow, (2) incompatible covenants and agreements with existing tenants that require the preservation of traditional anchor store or retail uses, (3) neighborhood and community opposition, and (4) outdated zoning laws that would prohibit such uses. Finding creative and effective workarounds can add tremendous value, and can mean the difference between project success and failure.

Understanding the Risks – Potential Obstacles and Impediments to Redevelopment

Prior to undertaking the redevelopment of an obsolete anchored retail strip center, enclosed mall or similar retail project ("Shopping Center") to include non-traditional retail uses, or evolving food uses such as so-called "ghost kitchens," or warehouse/industrial uses such as "last mile" fulfillment or distribution centers, it is imperative that the owner/landlord/developer ("Developer") understand whether the proposed change in use will be impeded by local zoning laws and ordinances, tenant exclusives or restrictive covenants found in one or more tenant leases, loan agreements, or in one or more declarations of covenants, easements and restrictions ("CCRs") or similar recorded documents that govern and regulate the shared use and occupancy of a Shopping Center. The Developer's review of applicable law and all applicable leases, loan agreements, and CCRs, with assistance of counsel, should be exhaustive and comprehensive, to ensure that Developer (1) understands whether it will be necessary to seek zoning relief (such as a PUD modification, a variance or special exception), or even a rezoning of the subject

property to authorize the desired new use; (2) understands the full range of applicable lease restrictions and tenant exclusives and how they could affect the proposed redevelopment, (3) identifies, if applicable, whose approval or waiver (such as a tenant, adjacent property owner, public or private utility, county or municipality, etc.) will be required for the redevelopment to proceed, (4) identifies and formulates a strategy to exploit any ambiguities, inconsistencies or other “grey areas” in applicable tenant leases and CCRs, (5) identifies any loan covenants that conflict with the proposed redevelopment and, if necessary, engage with the lender to obtain the appropriate consent, and (6) prepare strategically for negotiation with applicable tenants or parties benefited by a restrictive covenant or exclusive or, in the case that zoning relief is required, with interested parties in the community whose support may be needed.

Why Is Conversion from Retail to Industrial Happening?

The conversion of defunct or dying shopping centers to fulfillment or distribution centers is a growing phenomenon as the result of the rapidly growing popularity of online purchasing, which has been greatly accelerated as the result of COVID-19.

While large-scale e-commerce distribution centers have been around for many years now, they used to be located primarily in sparsely populated, rural areas where few customers were located, in order to avoid conducting business operations that would allow states to reap sales taxes on the goods sold. In recent years, however, the priority has shifted toward locating fulfillment centers in close-in suburban areas, or in downtown urban locations, to ensure the fastest possible delivery times, and to reduce costs and environmental impacts of delivery.

For Prepared Food Chefs and Operators, What is Causing the Trend Towards More “Ghost Kitchen” Establishments

A “Ghost Kitchen” is a professional food preparation and cooking facility set up for the preparation and delivery of meals, with delivery often accomplished by the use of third-party apps like Grubhub, UberEats, and DoorDash. Ghost Kitchens typically have limited square footage and no visible storefront, and will often include shared commissary spaces with other Ghost Kitchen operations, or may even share kitchen space with an under-utilized, unaffiliated full service restaurant operation. As part of the ongoing evolution of the retailer-to-consumer experience, Ghost Kitchens are a way that restaurants can take advantage of the boom in delivery business, while keeping occupancy costs in check. Ghost Kitchens are also an avenue for restaurant entrepreneurs to test their product before fully committing to a food truck or brick and mortar location. For the smaller brick and mortar restaurant owner, these Ghost Kitchens will allow them to launch a virtual brand and have more visibility to customers they would normally not have access to, and maximize the use of their otherwise sunken rental cost. For larger, more established, brick and mortar restaurants, Ghost Kitchens provide a way to expand into new geographic areas at a much lower cost.

Zoning and Land Use Law Compliance, and Making the Case for Relief

If a Developer is seeking to introduce a fulfillment or distribution center to a Shopping Center, understanding whether conversion to a warehouse or industrial use is permitted by applicable zoning ordinances or by the terms of an approved PUD for a particular project locations is a critically important first step in the redevelopment process. Each case will be different, but is there a way to argue that a fulfillment center or distribution center falls within the applicable definition of a retail use or otherwise complies with approved zoning in effect? Seeking a determination of compliance of the proposed use with zoning from the local government may be a big help. In cases where the zoning clearly does not allow the proposed conversion to industrial or warehouse use, the Developer will need to engage land use and zoning counsel to assist with the rezoning process. A few potential issues that could affect the potential for rezoning are addressed below.

- (1) Local governments may resist rezoning for industrial use if doing so will result in a loss of retail jobs and significant sales tax revenue, even if an industrial use will be a more viable long-term employer in a changing retail economy.

In response, a Developer could argue that the retail jobs and tax revenue are already lost, due to a fundamental shift in the retail economy. Conversion to an industrial warehouse use may in fact be the highest and best use of the site, which will result in new warehouse jobs and an increase in tax revenue.

A Developer may find greater acceptance if the proposed use is a hybrid between a pure fulfillment center and a retail anchor location. In the examples used in this session, Bargain Value Mart had proposed converting 50% of its space to a warehouse in support of its “click and collect” customer

purchase model, and as a return center for online purchases. The remaining 50% of the space would be used as a reduced-size store and showroom, encouraging foot traffic to the Shopping Center.

- (2) Local governments may also resist approving a change in use if the proposed fulfillment/distribution center site lacks sufficient access to main arteries and interstate access points. The inability to move freight and to make customer deliveries efficiently from a proposed fulfillment center location would pose a challenge.

In response, a Developer must carefully evaluate whether the proposed fulfillment center location satisfies those concerns, and must be able to make the case that authorization of the proposed use in a location very close to the consumer will result in greater efficiency of service, fewer overall miles driven in the delivery process, and a lower overall environmental impact.

- (3) Local governments will often react to community concerns over a change to industrial use, which concerns include (a) the proximity of a high-impact industrial use to residential neighborhoods; (b) reduced quality of life in vicinity of use due to 24/7 operation and increased traffic congestion, (c) loss of critical retail services within walking-distance to residential neighborhoods; (d) loss of retail jobs as the result of the conversion to industrial use; (e) other environmental impacts such as reduced air quality and noise.

In response, Developers seek to educate the community as a means to allay concerns, and should carefully explore whether slight modifications in the proposed use could help bring the community around. For example, if feasible, the Developer could propose (a) limiting the hours of operation or at least of freight delivery, (b) prohibiting truck idling and air-braking during restricted hours, (c) screening of parking areas to avoid light and noise pollution, and (d) restricting traffic to certain designated routes. Promoting the use of electric delivery vehicles would certainly address community concerns regarding air and noise pollution.

- (4) There likely will be less local governmental involvement and/or community concern with regard to converting former retail/restaurant space into Ghost Kitchens, as there are “plusses and minuses” in going that route. For example, although the frequency of drivers entering and leaving the Shopping Center may increase, overall parking availability should improve as there will be less customer parking demands within the Shopping Center.

Identification of Tenant Exclusives and Restrictive Covenants

Whether included in a lease or in CCRs, a wide range of tenant exclusives and restrictive covenants benefiting tenants or third parties could deal a fatal blow to Developer’s plans to redevelop portions of a Shopping Center to include a fulfillment or distribution center use if left unaddressed. There are limitless kinds of restrictive covenants that could impede development, but typical exclusives and covenants might include the following:

- (1) restrictions on certain “prohibited uses” and the introduction of new uses that were deemed incompatible with the original uses in the Shopping Center;
- (2) restrictions that would prohibit uses that directly compete with permitted uses of major tenants (including major tenants who may use a portion of their leased space to fulfill e-commerce orders);
- (3) restrictions preventing horizontal or vertical expansion of the Shopping Center building footprint, which could become an issue if the fulfillment center will require either a new building or modification of existing building;
- (4) restrictions prohibiting relocation, removal or addition of new drive aisles, loading docks, points of entry, and access and loading routes within the Shopping Center, or the removal, addition, or relocation of parking facilities serving the Shopping Center;
- (5) restrictions requiring tenant or third party approval to the alteration, removal or addition of any “common areas” described in a lease or CCRs, such as might be required for the addition of new loading dock areas, truck turn-around areas, etc.;
- (6) restrictions requiring tenant approval of any rebranding or renaming of the Shopping Center;

- (7) restrictions that would prohibit new construction within a certain distance of existing improvements, or within a so-called “no-build zone” provided for in other tenant leases, or in a location that would obscure the view of an existing tenant’s location from a street or highway;
- (8) restrictions against relocating certain public or private utilities without consent of the benefited utility providers; and
- (9) covenants or restrictions often entered into at the time of initial construction that benefit adjacent property owners, such as covenants that would limit building expansion rights, prohibition on certain kinds of noxious uses, etc., as a means to elicit neighborhood and community support for the development.

Assessing the Impact of Tenant Exclusives and Restrictive Covenants on Proposed Redevelopment

It is imperative that the Developer fully appreciate all potential obstacles to a Shopping Center redevelopment. To that end, the Developer should, with assistance of counsel, compile an organized master list of all tenant exclusives and restrictive covenants affecting the Shopping Center. Developer would be well-advised to order a title update to ensure that all restrictive covenants burdening the Shopping Center, and all amendments thereto, are identified and reviewed. As Developer and counsel undertake the analysis and review of the documents, the following questions would be useful to consider:

- (1) Ambiguous Restrictive Covenants and Exclusives. How clear and unambiguous is the restrictive covenant or exclusive? Is there any room to reasonably interpret the plain language of a restrictive covenant in a way that would obviate its negative effect on the redevelopment, or form the basis for a negotiation with the benefited party? As we saw from Fact Pattern No. 2 in the Peer to Peer workshop, the fact that Thai Garden’s tenant exclusive prohibited another “full service” Thai restaurant left the door open for the landlord to assert that introduction of a “ghost kitchen” Thai restaurant with a delivery-only business was not a “full service” Thai restaurant, and that Thai Garden’s tenant exclusive did not apply. At the very least, ambiguities or inconsistencies in the documents that establish the restrictive covenant or exclusive could serve as the basis for a negotiation with the tenant or benefited party.
- (2) Void or Unenforceable Restrictive Covenants and Exclusives. Does the lease or restrictive covenant describe any circumstances that could render the covenant void or unenforceable? If so, have any such circumstances arisen? For example, if Thai Garden had closed its location but was still paying rent, could Developer argue that Thai Garden had abandoned its exclusive rights to operate a full service Thai restaurant in the Shopping Center?
- (3) Abandonment of Easements. Can a case be made that an easement benefiting a utility or a neighboring owner has been abandoned? For example, In the case of CCRs establishing underground utility easements which cannot be relocated, is the easement still being used? Or would a non-exclusive easement for shared parking in favor of a now-closed neighboring commercial center be abandoned upon non-use for a period of years? Could an old restriction barring certain competing retail uses for the benefit of a neighboring commercial property be deemed abandoned if the neighboring property were redeveloped as multi-family residential and without any retail uses?
- (4) Changing Context of Language in Restrictive Covenants and Exclusives. Upon becoming familiar with applicable law regarding the construction and enforceability of use restrictions, counsel should explore with Developer ways in which the wording of an old restrictive covenant or tenant exclusive can be narrowly construed or determined to be inapplicable in an evolving retail environment. For example, if an existing pizzeria lease includes an exclusive prohibiting Developer from leasing to a “pizza restaurant” within a certain radius from the tenant’s location in the Shopping Center, would that prohibit leasing to a delivery-only ghost-kitchen restaurant that prominently features a new “flatbread” concept that some would argue is a new kind of pizza by another name?
- (5) Making Maximum Use of Defined Terms. It is also worth exploring whether defined terms in CCRs or a lease, or a lack thereof, create an opportunity for Developer to justify a proposed redevelopment despite being contrary to existing tenant exclusives or restrictive covenants. Consider, for example, a lease or covenant that narrowly defines “Shopping Center” to include the retail uses upon a specific parcel or within a specific building or complex of buildings, but is silent as to whether “Shopping Center” would include adjacent properties owned or purchased by

Developer, or space that is no longer used for “retail uses”. Would a tenant exclusive or restriction applicable to the “Shopping Center” prohibit Developer from developing an adjacent parcel with uses that would violate the restrictive covenant?

- (6) Determining Whether Benefited Party Retains Standing to Oppose Redevelopment. Developer should explore whether the terms of the lease or restrictive covenant impose any limitations on the ability of the tenant or benefited party to oppose the redevelopment. For example, does the lease or restrictive covenant include a “deemed consent” provision that would limit the timeframe within which the tenant or benefited party could effectively raise objection? Or has the exclusive or restrictive covenant expired on its terms? Is there a lease provision that would terminate a tenant exclusive, or render it unenforceable, upon a monetary default or upon a violation of any other lease terms?
- (7) Understanding State, Local and Common Law Applicability. Developer’s counsel should be familiar with applicable law, including any recent case law developments. Given the frequency of disputes involving allegations of breaches of tenant exclusives and restrictive covenants, helpful judicial guidance may be available.

Assessing Risk of Violating the Restrictive Covenant or Tenant Exclusive.

Only rarely will a Developer consider forging ahead with a proposed redevelopment in the face of a potential claim of breach of a tenant exclusive or restrictive covenant, and with good reason. For starters, doing so without first addressing or resolving the potential claim may make it impossible to secure financing for the redevelopment, and may make it very difficult to attract new tenants with such issues unresolved. Accordingly, it would be generally unwise to consider moving forward under such circumstances. It is fair to say that counsel should encourage Developer clients to honor restrictive covenants and tenant exclusives, even those terms that do not suit them. Care should be taken, of course, to ensure that the Developer would not be violating any of the terms of existing financing by intentionally breaching a tenant exclusive or terms of any CCRs.

Before dismissing the idea out of hand, however, Developers and their counsel should fully assess the inherent risks and potential costs of moving forward without first addressing the restrictive covenant issue. Doing so will also help Developer understand the extent of the tenant’s or benefited party’s leverage in a negotiation over the issue.

For example, are there express limitations on the tenant’s or other benefited party’s remedies or limitations on their measure of damages upon Developer’s violation of the restrictive covenant or tenant exclusive? If the worst case scenario for Developer upon a breach of an exclusive is only a partial rent abatement for a small retail tenant, or the right for the tenant to terminate its lease prior to expiration of the term, or perhaps a reasonable liquidated damages payout to the benefited party, then the Developer might determine that it would be worth the risk to proceed. If nothing else, such information might be useful information in a negotiation with the tenant to obtain the tenant’s waiver or consent to the proposed redevelopment.

On the other hand, if the lease or restrictive covenant is silent on the remedies and on the potential measure of tenant’s or benefited party’s damages, then there may be no way to proceed. The cost of defending a lawsuit alleging breach of contract and seeking injunctive relief and uncapped monetary damages (including consequential damages) would dissuade most Developers from ignoring the risks of violating a tenant exclusive or restrictive covenant.