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Workshop 20

Mixed Use Developments: Putting the Puzzle Together Today. Providing Flexibility to Rearrange Tomorrow

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Mixed Use Developments:

Putting the Puzzle Together Today. Providing Flexibility to Rearrange Tomorrow.

Mixed-used commercial developments come in a variety of shapes and sizes, as well as mix of uses. It is the current in-fashion development buzz-word having succeeded the last major retail innovation – the life-style/entertainment center. In many respects, it is an evolution of the life-style/entertainment center, as the mixed-use commercial development often adds a significant "work" and "live" component to the "play" component.

This workshop focuses on some of the challenges real estate lawyers need to address when representing the developer or occupant of three types of mixed-use developments having a significant retail/entertainment component. The three mixed-use developments types that will be discussed are: (1) a multi-block new urbanism development, (2) a vertical high-rise development and (3) a repurposed regional mall. The most common non-retail/entertainment uses in these developments are office, residential, and hotels. However, other more public/civic uses, such as parks, transportation hubs, libraries, police stations and schools are not uncommon.

The challenges these developments face are often similar – (1) how to integrate uses that may have competing interests or conflicting needs, (2) how to create a legal and operational framework that allows for each component of the development to be successful, (3) how to equitably allocate development related operating expenses, such as taxes, common area costs and parking expenses, and (4) how to build-in flexibility to the legal and operational framework to allow the mixed-use components of the development to change and evolve in accordance with market-driven demands.

These developments also have unique characteristics. The multi-block new urbanism development may have issues related to phased development and financing of individual blocks within the development, and whether the roads and sidewalks will remain "private" or be dedicated and become "public" improvements. The vertical high-rise development may have issues related to high demand for limited building service areas, such as delivery and trash areas, elevators and parking, and operational issues related to a central HVAC plant. The repurposed regional mall may have issues related to restrictions and limitations that cannot easily be modified or changed in an existing declaration or reciprocal easement agreement, or under existing leases that will continue after the redevelopment.

Working through these challenges and issues is a puzzle, time intensive, often costly, requires a layering of multiple documents that will all work together, and sometimes takes years. The size and scope of these developments and the potential impact that they may have on their community are what justify these efforts.

Multi-Block New Urbanism Development

New urbanism is the return of an old idea that mixed-use multi-block developments are more dynamic and walkable and can create vibrant and more diverse communities. These developments have been encouraged by cities as a redevelopment tool and to curtail traditional suburban developments that provided for separate retail, residential and office projects. Around the country, cities have encouraged these developments (1) on former manufacturing plants, closed hospital campuses, repurposed airfields and other blighted areas, and (2) to create vibrant greenfield "town centers" in suburbs. Because cities are a key driver in new urbanism projects, the development agreement between the city and the developer is central to the success of the project.

The developer will seek a variety of incentives from the city based on what is statutorily available in the applicable jurisdiction. These incentives may include tax increment financing or abatement, issuance of bonds for needed public improvements, such as new utility lines, streets and parking garages, and public/private partnerships to clean-up environmental contamination on-site and provide public transportation hubs. The developer may also seek to layer certain "community benefit" taxing districts on the project that allow the developer to impose and capture sales taxes to pay for project amenities, such as security, enhanced lighting and maintenance of public squares and parks.

The city will seek assurances from the developer that, in return for the financial investment the city will be making through the incentives package, the developer will actually complete the project as approved by the city within an agreed upon time frame. The city also will want to participate in the success of the project by recapturing all or portions of parking fees paid and receiving payments from the developer if certain project financial benchmarks are reached. Similarly, if the project is unsuccessful or the developer fails to fully perform its obligations, the city will want "claw-back" provisions that result in the loss or sunset of certain city incentives that were granted and/or loss of certain development rights. Needless to say, this part of the development process is typically highly political and receives significant public scrutiny. The public process often results in a re-scaling of the scope and density of the project.

The scale of new urbanism projects often results in the developer partnering with, or selling components of the project to, others with greater expertise in a development component. For example, a residential or hotel developer may be brought in for those components. Before the developer sells components of the project or even if the developer intends to be the sole developer of all components, the developer will want to put in place a detailed declaration that will govern the operation of the project and the relationship, rights and obligations of occupants and potentially multiple owners and lenders.

The declaration is the second layer of control after the development agreement and the declaration should address, among other issues, the following key issues: (1) whether approval rights under the declaration are reserved to the developer or granted to an association, (2) how assessments will be made to the various components for reimbursement for operational and common area expenses, (3) easement rights, (4) what parking controls and charges can be put in place (i.e., can certain parking spaces be reserved exclusively for certain uses on certain days and at certain times), and (5) when disputes arise, what mechanisms are available to resolve those disputes without resorting to lengthy and expensive litigation.

Because new urbanism projects are often developed in phases and by blocks, it is common for phase or block declarations to be layered on the master declaration for the entire project. This allows the master declaration to cover the issues that will be common to the entire project and the phase or block declaration to cover more specific and unique phase or block issues. The layering of declarations requires careful attention by the drafter to insure consistency and avoid conflicts.

The layering of declarations can also be helpful to a lender providing financing for a phase or block. Properly drafted, the phase or block declaration will enable the lender to understand and correctly underwrite the risk. For example, if the phase or block declaration provides for the parking required by law on such phase or block, the lender will be comfortable that a foreclosure will allow the phase or block to operate independent of the other phases or blocks. If, however, the phase or block is dependent on parking located on a block outside the property subject to the mortgage, the lender will need to understand what effect the loss of parking on such other block (e.g., due to casualty, condemnation or some other reason) will have on the value and usefulness of such property, and ensure that agreements are in place to preserve rights to such off-block parking or replacement parking.

There is, of course, a further layer of issues once the various mixed-uses are open for business. A night club operating until 2:00 am on the first floor of a residential building may generate noise and vibrations that make it difficult to lease or sell residential units proximate to the night club. Similarly, a restaurant may create odors, noise or trash that is difficult to fully mitigate. A grocery store may be adversely affected if the closest parking spaces are occupied by office employees. A hotel and theatre may compete on the same critical weekend days and hours for prime parking spaces. In contrast to a typical shopping center development, a common set of operating hours is the antithesis of a mixed-use development.

The declaration or individual leases are common places to address these operational issues. The developer can restrict parking on the first floor of parking structures or in other prime parking spaces to after 10am only in order to prevent office tenants from monopolizing these spaces from 8am to 5pm. The developer can also require that construction not start before 8am so as not to disrupt the sleep of residents and hotel guests. It is challenging, however, to require a successful restaurant or night club to close by 9pm. Here is where careful planning is crucial so that restaurants, bars and other entertainment venues are situated in locations where they will cause the least disruption to residents and hotel guests. The location of elevator access for rooftop bars and restaurants also need to be carefully thought out. Residents and other commercial tenants will not be happy if the lobby to their building is packed late night with club goers awaiting access. Security can also be an issue in mixed-use projects. Residents and office tenants will not want club goers and other restaurant/retail customers walking around office buildings, residences and hotels. Exits and entrances will need to be clearly marked and access restricted to these areas. Common area lighting also needs to be carefully planned out. A lighting study can be prepared to determine to appropriate lumen intensity for signs and parking lot lots so as not to disturb residents and hotel guests.

Retail tenants who are used to obtaining project-wide exclusives may need to get comfortable with having limited or no exclusives. Similarly, retail tenants may be unable to get any meaningful co-tenancy provision, and may need to settle for an opening co-tenancy. The opening co-tenancy may be loose and more a commitment to build a certain amount of square footage for certain types of users (e.g., a multi-family residential building containing a minimum number of units). Because of the many moving parts of new urbanism projects, the developer may be granted a number of years to comply with any co-tenancy requirements before an occupant is entitled to a remedy.

Finally, there are cost sharing issues related to taxes, insurance, project-wide common areas, phase or block specific common areas and parking garages. There are certain common area expenses that benefit all of the occupants in a mixed-use project (for example: parking lot maintenance, lighting, security, landscaping, sidewalks, exterior building maintenance), however, other expenses only benefit the residential occupants and/or office tenants (for example: elevator maintenance, fitness centers and pools). There is no one way or right way to allocate these expenses. The key is for the charges to be transparent, verifiable and equitably allocated. Sometimes the documents simply provide that the developer, in its sole judgment, will equitably allocate these costs among the occupants. This language is a lawsuit waiting to happen, as the occupant will have no ability to verify whether or not the costs were actually equitably allocated. Sometimes the developer sets up cost accounting by blocks, with only the occupants of a block paying the costs associated with such block. This may work well for taxes if a block is separately assessed, but not so well if a block benefits from common areas on another block, or if certain of the mixed-uses are higher users of certain common areas. After considering the difficulty in equitably passing-through these operational costs and the administrative costs that will be incurred each year, some developers settle on a fixed contribution by occupants that is adjusted annually by an agreed upon escalator. These fixed contribution provisions may also include a reset of the fixed contribution based on actual experience every 5 or 10 years.

Below is an example of how common area expenses were allocated in a retail lease where the retail tenant was located on the first floor of a residential building:

The formula to compute Tenant's Pro-Rata Share of Non-Severable Operating Expenses (i.e., Operating Expenses for the entire Mixed-Use Project) is as follows: (i) Divide the Total Leasable Square Feet of the Retail Community by the Total Leasable Square Feet of the Entire Mixed-Use Project ("**Retail Footprint Quotient**"); (ii) Divide the Total Leasable Square Feet of the Demised Premises by the Total Leasable Square Feet of the Retail Community ("**Premises to Retail Footprint Quotient**"); (iii) Multiply the entire Non-Severable Operating Expense by the Retail Footprint Quotient ("**Total Retail Impact Product**"); and (iv) Multiply the Total Retail Impact Product by the Premises to Retail Footprint Quotient to arrive at Tenant's Pro-Rata Share of Non-Severable Operating Expenses.

By way of illustration only, using "round numbers" for the sake of simplicity, the following serves as an example as to how Landlord shall calculate Tenant's Pro-Rata Share of Non-Severable Operating Expenses: (i) Landlord divides the 10,000 square foot total leasable area of the Retail Community by the 350,000 square foot total leasable area of the entire Mixed-Use Project in order to reach a Retail Footprint Quotient of .029 or 2.9%; Landlord divides the 1,500 total leasable square foot Demised Premises by the 10,000 total leasable square foot Retail Community to reach a Premises to Retail Footprint Quotient of .15 or 15%; (iii) Landlord multiplies the entire Non-Severable Operating Expense of $350,000.00 by the Retail Footprint Quotient of .029 in order to reach the Total Retail Impact Product of $10,150.00; and (iv) Landlord multiplies the Total Retail Impact Product of $10,150.00 by the Premises to Retail Footprint Quotient of .15 in order to render final calculation of Tenant's Pro-Rata Share of Non-Severable Operating Expenses at $1,522.50 for the Lease Year. Consequently, under this example, applying Landlord's formula to compute Tenant's Pro Rata Share of this Non-Severable Operating Expense, Tenant's monthly charge for Real Estate Taxes would be $126.88.

Vertical High-Rise Development

There are some similarities between a new urbanism development and a vertical high-rise development. The scope and size of the project and its impact on the typical urban area in which it will be constructed will cause the developer to seek a city incentives package requiring a city development agreement similar to that for a new urbanism development. The developer will also need to thoughtfully address the sharing of costs for common shared services and facilities, such as for deliveries, trash, parking, HVAC, elevators, and lobbies. For these issues, the discussion under the new urbanism section remains relevant.

There are, however, some issues that are more unique to a vertical high-rise development. First, in contrast to the often phased development of a new urbanism project, the vertical high-rise development will likely be built in its entirety at one time. If the project will include retail, office and hotel components, negotiations of key leases for the retail and office components, and a management agreement for the hotel component will likely be requirements before a lender will release funds to commence construction. The need for these key leases and hotel management agreement can give these occupants leverage over the developer to obtain more favorable terms then they might otherwise be able to obtain. The developer will be under pressure to get the project under construction and comply with development time lines in the city development agreement and the lender loan commitment time lines.

Second, the vertical high-rise development is often owned and controlled by one entity, negating the need for a master declaration addressing the rights of multiple owners and lenders. However, this is not always the case and a number of vertical high-rise projects are developed as condominiums so that the key components (such as retail, office, hotel and parking) can be separate units with separate owners and lenders. The condominium structure, due to statutory requirements, is a more rigid governance structure than the declarations and reciprocal easement agreements typically used in new urbanism and repurposed regional mall projects. This more rigid and inflexible structure is less an issue in vertical high-rise projects as the physical constraints of such projects make the need for flexibility to reconfigure the project over time less likely. The condominium regime is helpful for obtaining separate assessment of taxes, and segregating areas of the project in which a unit owner has exclusive control and sole obligation to maintain and repair.

There is one area of expenses in a vertical high-rise development that requires added attention – the central HVAC system. The engineering constraints of a vertical high-rise development typically requires the construction of one heating and cooling plant to serve the entire project. Equitably allocating the costs of this plant, including costs of periodic capital improvements, maintenance personnel and utility consumption, can be a real challenge. The hotel is a 24 hour operation, whereas the retail and office components have more limited hours, but may have more intensive needs during those limited hours. There are ways of measuring consumption of utilities by the different components, but it is not always as easy a one would hope, and the accounting of what costs of the central plant can be passed-through to occupants and what should be excluded is as complicated as inclusions and exclusions for common areas in a more traditional shopping center.

I was involved some time ago in a dispute between a major retail occupant of a vertical high-rise development, the owner of the retail condominium unit in which the retail occupant's premises were located and the owner of the hotel condominium unit in which the central plant was located. Because the central plant was located in the hotel condominium unit, the hotel condominium unit owner had the responsibility to maintain and repair the central plant subject to agreed-upon percentage reimbursements by the other condominium unit owners. The retail condominium unit, pursuant to an easement agreement between the condominium unit owners was assigned a specific percentage (e.g., 25%) of all central plant costs incurred by the hotel condominium unit owner without much specificity as to permitted inclusions and exclusions from such costs, and with limited audit rights granted to the retail condominium unit owner. The major retail occupant had negotiated a lease with typical common area inclusions and exclusions and audit rights, but without fully understanding that the central plant was not controlled by the retail condominium unit owner. When the retail condominium unit owner sought to pass-through to the retail occupant significant central plant costs, the retail occupant exercised its audit rights to confirm that only permitted costs were passed through. The lack of consistency between the lease and the easement agreement, including the inability to fully audit the central plant costs led to a lawsuit as to what the retail condominium unit was allowed to pass-through.

Finally, the vertical high-rise development inherently has issues related to construction build-out of spaces, delivery of construction materials, staging areas for construction, access to delivery areas, use of elevators during construction, and permitted times that construction can occur. The limited availability of construction staging and access areas, and limitations on when construction can be performed lengthens the time period for completing projects and adds significantly to costs. These issues all need to be addressed in detail as part of the relevant documents to avoid conflict and ensure a consistent application of rules and procedures for all occupants.

Repurposed Regional Mall

The challenges of converting a regional mall into a mixed use project begin with first looking backward before moving forward. The developer will need to understand the limitations and restrictions contained in the underlying documents.

The most important document to review will be the reciprocal covenants, operations and easements agreement (RCOEA). The RCOEA will likely be a multi-party agreement between the original developer and major department stores in the regional mall. Because the RCOEA was intended to create a successful enclosed retail mall, there will be many provisions in the RCOEA that will create potential road blocks to the repurposing of the regional mall to a mixed-use development. Some of those provisions are: (1) limitations on where buildings can be constructed, (2) parking ratios that exceed what is required by a mixed-use project, (3) required approvals of department store tract owners to major project changes, and (4) use restrictions that limit permitted uses of the project to retail uses and prohibit large categories of other uses, such as theatres and other entertainment uses, residential, office, discount retailers, medical offices and facilities, and hotels.

All of the foregoing RCOEA issues can be overcome if the developer owns all of the enclosed mall parcels. However, that is often not the case. While the developer may have recaptured one or more department store parcels, such as one formerly owned by Sears, other department store parcels and outparcels may have new owners with occupants, such as Target, a movie theatre, other big box users, a bank or a restaurant, which can operate successfully regardless of whether the enclosed mall remains viable. They are not looking to be bought out, even if the developer makes a significant offer. They are looking to remain in the project as it is redeveloped and be part of a new vibrant project. Obtaining their consent to a modification or restatement of the RCOEA becomes a significant challenge, which is in addition to the design challenge of designing a new project that include these holdover occupants and architectural restrictions put in place for a regional mall.

Many of these existing regional malls have out lots with drive-thrus which can be a logistical nightmare. As we have seen, restaurants with drive-thrus have done a booming business during the pandemic and the convenience they offer will likely continue to be in high demand for many years to come. Drive-thrus, however, are often highly disliked by all of the other occupants in the project. The customer never leaves its car so he or she does not patronize the other retailer and cars often line up in areas blocking parking and access for the other buildings in the project. I'm thinking of one highly successful restaurant tenant in particular where the queuing of cars though out the mixed-use development has required police involvement directing traffic and the developer has received numerous complaints from other occupants about the lack of available parking and access. Careful planning is necessary to ensure that cars do not queue up outside of drive-thru restaurant parcels, however, when repurposing existing developments, the developer often inherits an existing site plan that was not designed to accommodate the high demand of drive-thru restaurants today.

Sometimes redevelopment challenges can be overcome due to the large area occupied by the enclosed mall. The new project might be broken into zones, with the holdover retail occupants being confined to a smaller retail project, while other portions of the project become exclusively office, residential or hotels – essentially multiple reuses of the enclosed mall that can stand alone as independent projects satisfying their own parking needs. However, if the goal is to create a new urbanism type project, then working with the existing occupants, while putting in place the underlying declarations discussed in the new urbanism section above, becomes complicated.

Other owners of portions of the enclosed mall are not the only parties that may have rights. There may be long term leases, with multiple option periods remaining to be exercised, that have their own set of use restrictions and required improvements. There may be utility easements that need to be relocated and which require the approval of utility companies. There may be city issues with reconfiguring access to adjacent public roads, as well as creating new roads within the project.

The developer will need to put in place a detailed phasing plan that addresses: (1) maintaining key access and parking areas for the remaining occupants while demolition and construction proceeds, (2) implementing construction procedures related to noise generating activities and hours that construction work is permitted so as not to adversely affect the businesses of the remaining occupants, and (3) providing signage to direct customers to those occupants remaining open. In addition, the developer may need to put in place a new regime for sharing of common area costs. The traditional pro rata share of floor area approach may be too simplistic. Finally, the developer may try to look in the future as far as it can and build in flexibility to modify the development in the future so as to avoid the very difficult issues it encountered in repurposing the existing enclosed mall.

Conclusion

Mixed-use developments are often complicated, requiring the real estate attorney to apply all of his or her skills to understand existing underlying operational documents, the role of key players in the development (including the city and ultimate users), and the business vision of the developer. The real estate attorney will need to craft new documents that can hopefully survive the test of time and be flexible enough to address the unknown future. Mixed-use developments are a legal puzzle that require a thoughtful and well documented scheme to ensure that all the pieces fit and work together.