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Workshop 8

**Residential Development and Use in Shopping Centers:
Legal Challenges of Evolving From a Noxious Use to a Desirous Use**

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THE CHALLENGES OF INTRODUCING A RESIDENTIAL DEVELOPMENT AND USE TO AN EXISTING TRADITIONAL SHOPPING CENTER

I. BACKGROUND

A shopping center is the term for a large enclosed or outdoor integrated grouping of retail stores, usually containing a “mall” and traditionally anchored by department stores. The term “mall” originally meant a pedestrian promenade with shops along it but, beginning in the 1960s, it became a common reference for the largely enclosed shopping centers that were becoming popular, especially in the suburban United States.

The suburban shopping center concept began to expand in prominence during the early to mid - twentieth (20th) century. During its evolution, shopping centers (and their component malls) were envisioned not only as centers for retail sales, but also as cultural and social community centers where people could come together and interact socially.

However, since then, many shopping centers and their malls have declined, both physically and in terms of social and retail popularity. To combat this decline, and in an effort to revive the communal intentions of shopping centers and their malls, Shopping Center Owners have begun to incorporate many non-traditional (in some instances historically prohibited or so-called “noxious”) uses at their shopping centers. For instance, Shopping Center Owners have added entertainment and experiential features, added big-box stores as anchors in lieu of traditional department stores, and added large health clubs, electric car dealerships, grocery stores, groupings of sit-down dining and movie theaters.

At a time when many brick-and-mortar retailers are struggling and physical retail faces difficult competition from e-commerce, Shopping Center Owners are increasingly considering residential use as both a new revenue source and a way to invigorate the retail components of their shopping centers (and malls) by placing potential consumers in close proximity; in doing so, Shopping Center Owners seek to create so-called “mini-cities” with grocery stores, retail shopping, entertainment, exercise facilities and restaurants at one’s doorstep.

However, this new eclectic mix of uses, and in particular adding a residential use and development to an existing retail shopping center, presents significant legal and operational challenges.

This article will discuss some of the basic legal and operational challenges of adding residential use and development to an existing traditional retail shopping center, highlight common issues that need to be addressed and resolved, and, as part of our Workshop discussion, we will address potential resolutions to these challenges.

As a general note, when we refer to “*Shopping Center Owners*” in this article, we are generally referring to the entity that owns the so-called enclosed mall area of the shopping center or, in the instance of an open-air outdoor center, the area of the shopping center in which the bulk of the in-line stores are situated.

II. REA’S AND THEIR HISTORIC IRONY

What many consumers do not realize when they frequent their shopping center of choice is that the Shopping Center is not, in fact, owned by a single owner. Instead, the ownership of your typical shopping center is comprised of multiple owners: namely, a Shopping Center Owner that owns the enclosed mall or open-air outdoor inline retail area, as mentioned above, and many of the common areas and roadway access points (e.g., the ring road and the like); anchor retailers that own many of the retail “boxes” and surrounding parking areas immediately adjacent to the enclosed mall or outdoor inline retail area; and outlot owners that own many of the restaurants and stand-alone retail stores that are often located outside of the shopping center’s ring road.

In order to integrate these various owners and parcels into a single operable shopping center unit, so-called Reciprocal Easement Agreements or Operation and Easement Agreements (in either instance, “*REA’s*”) were created. In short, an REA is the legal agreement, typically recorded against the entire shopping center, that enables individually owned parcels to be assembled into one large contiguous and integrated property for specified purposes and uses, setting forth the responsibilities of the various owners and regulations governing each. Said another way, REA’s ensure that all parties possess rights and abide by rules pertaining to all of the operations at the shopping center such as vehicular and pedestrian access via roadways and sidewalks, parking spaces and locations and permitted parking areas, permitted and unpermitted types of business operations, permitted and

unpermitted common area uses, signage locations and specifications, initial and future construction and improvement locations, standards and responsibility for performance and cost of shopping center maintenance, and the like. In short, REA's are a shopping center's bible, setting forth the standards by which each component owner and operator must abide in order to be a part of an orderly shopping center community.

Historically, one of the basic tenets contained within REA's, was the protection of ample parking for all shopping center parcel owners, their tenants and their respective patrons. Consequently, many (if not most) REA's created in the 1970's, 1980's and 1990's, which are still governing shopping centers today, expressly prohibit certain uses at the shopping center that were then considered parking gluttons, such as health clubs, movie theaters, restaurants, entertainment facilities, hotels and residential buildings – namely, uses that might monopolize coveted parking spaces to the detriment of anchor and other traditional retail operators. However, given the economic challenges that shopping centers are facing of late, it is precisely these historically “noxious” uses that Shopping Center Owners are looking to attract in order to rejuvenate foot traffic and their shopping centers. Hence, the irony and challenge -- today's desired uses (including residential operations) are often prohibited by the REA's that govern the shopping centers (as well and many of the shopping centers' retail leases).

III. **WHAT ARE SOME OF THE MAJOR LEGAL AND OPERATIONAL CHALLENGES POSED BY ADDING RESIDENTIAL USES AND DEVELOPMENT TO A TRADITIONAL RETAIL SHOPPING CENTER?**

A. Unpermitted Use: As noted in Section II above, residential use is typically unpermitted in both REA's that govern the shopping center, as well as most retail leases at the shopping center. Note that the prohibition on residential use can be either express or implied -- either an express prohibition on residential, “lodging” or non-retail uses, on the one hand, or a requirement that only uses that are consistent with uses performed at first class (or comparable) regional shopping centers in the general proximity of the shopping center at issue are permitted, on the other hand.

Consequently, in order to accommodate residential use, consents will often be needed from each of the “Parties” (i.e., the then current owners of the parcels owned by the original signatories to the REA) as well as the tenants whose leases prohibit residential use. And often requests for those consents will be met with requests for some sort of reciprocal compensation...

B. Site Plan Control: A shopping center site plan is a drawing, not necessarily drawn to scale, that shows the existing and proposed property lines of the various ownership parcels comprising the shopping center and / or the specific location of all buildings and other improvements (and proposed improvements), appurtenances (driveways, ring roads, access points to adjacent roadways), parking areas (including all parking spaces and configurations), open space, landscaping, pylon signage locations and other development features, at the shopping center. Most retail shopping center REAs and leases have a site plan of the applicable shopping center attached as an exhibit to the applicable document.

i. Under the REA: The owners of the various anchor parcels typically, and sometimes their department store tenants, have full site plan control rights over the common areas in the shopping center as well the permitted building areas (“PBAs”) for buildings and other improvements at the shopping center, meaning that no changes can be made to those common areas and PBAs without their consent. And anchor owners (and their department store tenants with consent rights) are particularly protective of ring roads, access points to public rights-of-way and parking sufficiency.

ii. Under Shopping Center Leases: It is not unusual for significant tenants, both in-line and those unconnected to the enclosed mall, to have certain controls on limited portions of the shopping center specified in their leases. These controls are often identified as “protected areas,” “control areas,” “critical areas,” or “restricted areas”. Some examples of the areas or uses that significant tenants contain control over via their lease provisions include so-called “no build zones” at the shopping center (i.e., often to protect parking access and sight corridors to the tenant's space and signage), building height limitations (i.e., again to protect sight corridors), so-called “no change areas” for certain areas of the ring road and access points to public rights of way, parking ratios (to ensure sufficient parking for patrons), visibility corridors, among others. The lease often includes numerous references to the site plan exhibit and often contains a landlord covenant to ensure that specific shopping center elements / common area configurations be maintained throughout the lease term.

One of the greatest challenges facing a residential redeveloper at a shopping center is obtaining consent to reconfigure the common areas of the residential redevelopment parcel to allow for new buildings and improvements and new parking and roadway and access areas.

C. Common Area Charges and Maintenance Obligations: It is typical in many, if not most, REA's governing large shopping centers that (i) the Shopping Center Owner is required under the REA to maintain the common areas on other anchor parties' parcels, and (ii) the anchor parties contribute to Shopping Center Owner's maintenance expense via reimbursement obligations under the REA or separate bilateral agreements between the Shopping Center Owner and the anchor (e.g., so-called "Separate Agreements" or "Supplemental Agreements").

This becomes a significant issue that the Shopping Center Owner must address in connection with the residential development of a prior anchor retail parcel for two (2) reasons:

i. First, Shopping Center Owners are not typically equipped for the physical complexities, added potential liabilities and additional costs of maintaining more intricate and complicated residential sites as compared to typically simple anchor sites containing merely an anchor box and parking area; and

ii. Second, most REA's provide (via the "Separate / Supplemental" bilateral agreements mentioned above between the Shopping Center Owner and the anchor party) that the anchor party need not reimburse the Shopping Center Owner for 100% of Shopping Center Owner's actual cost of maintaining the anchor parcel's common areas. The reason is that the reimbursement obligations date back to the time of the initial development of the shopping center (i.e., 1970's / 1980's etc.), when the Shopping Center Owner needed the anchor party's participation at the shopping center in order to initially develop the center and, as a result, often offered "sweetheart" deals to the anchor to locate at the shopping center.

Consequently, the Shopping Center Owner will typically want to either (i) relinquish its obligation to maintain the residentially redeveloped anchor parcel and require that the residential homeowner's association maintain same going forward, or (ii) require that the residential homeowner's association reimburse Shopping Center Owner for the full amount of Shopping Center Owner's costs of maintaining the common areas on the residentially redeveloped anchor parcel.

D. Parking Ratio Issues: A parking ratio is the ratio that number of parking spaces in a given area of the shopping center bears to the square footage of the buildings located in that same area. Parking ratios are typically expressed as the number of parking spaces per number of rentable square feet of improvements; for example, as 1 parking space per 200 rsf of improvements or 5 parking spaces per 1,000 rsf of improvements. Note that is not uncommon to have different parking ratios required by the REA governing the shopping center, certain leases at the shopping center and pursuant to applicable law. Further, different uses typically require different parking ratios for optimal parking coverage. For instance, historically, it was customary for retail uses to be required to maintain a ratio of 5 spaces per 1000 rsf of retail improvements (now 3.5 – 4.0 / 1000 is more common) and for residential uses to be required to maintain a parking ratio of 1 parking space per unit bedroom.

Consequently, the parking ratios contained the existing REA's of record and leases at the shopping center might be outdated and likely will not apply logically to residential use.

E. Construction: Once a proposed residential project receives approval from the applicable governmental authorities and the plans therefor have been conceptually approved by the various stakeholders at the shopping center that have approval / consent rights as mentioned above (e.g., Shopping Center Owner, anchor owners and applicable shopping center tenants), the next major issue is to negotiate the delicate balance between allowing the construction to commence and continue, while at the same time not adversely impacting the overall operations at the balance of the shopping center. Some of the major issues that need to be addressed and resolved between the residential developer and the Shopping Center Owner (on behalf of the overall shopping center) include:

i. having the residential developer agree to abide by a construction schedule, staging and phasing plan;

- ii. determining the level of changes can be made to the approved residential development plans with and without the residential developer being required to obtain further consent from the shopping center stakeholders mentioned above;
- iii. appropriate screening of the redevelopment site and protection from dust, dirt and eyesore;
- iv. negotiating whether the residential developer must commence construction and, if so, whether it applies to the entire project or just certain phases;
- v. negotiating whether the residential developer need not commence construction but once commenced must complete construction;
- vi. negotiating the Shopping Center Owner's need to protect its property and retail tenants by ensuring that utility lines located on the residential redevelopment area servicing the balance of the shopping center are not disrupted during the construction stage;
- vii. ensuring that the residential redeveloper's use of shared utility lines do not exceed existing capacities to the detriment of the shopping center; and
- viii. negotiating the residential developer's insurance and indemnity obligations in favor of the shopping center as well as other conditions unique to the proposed construction, such as use of roadways by construction vehicles.

IV. DOCUMENTING THE PARTIES' AGREEMENTS TO ADDRESS THE FOREGOING LEGAL AND OPERATIONAL CHALLENGES

During our Workshop discussion, we anticipate the attendees discussing:

1. Ways to address each of legal and operational challenges mentioned above;
2. Ways to most appropriately document agreements / consents to the residential redevelopment from each of the anchors;
3. Ways to most appropriately document agreements / consents to the residential redevelopment from each of the tenants that hold approval rights; and
4. Whether REA's should be amended to permit the residential redevelopment or, perhaps, whether the REA's should be terminated as to the residential redevelopment parcels and replaced with new Covenants, Conditions and Restrictions Agreements ("CC&Rs") between the Shopping Center Owner, on the one hand, and the residential developer, on the other hand.