WE FINALLY GOT A PIECE OF THE PIE—

PERIMETER AND OUTPARCEL DEVELOPMENT

By Kathleen Dempsey Boyle, Cristina Hendrick Stroh, and Benno G. Rothschild

There have always been marketplace-driven changes, and outparcel development has long been part of the mix. But Internet sales and general economic sluggishness are driving a unique flip-flop away from parking-intensive megastores that were once a fixture of shopping center developments, creating new opportunities that the original developer may not have seen coming.

In the past, big-box users of all stripes were very focused on large parking fields. Today, big-box closings and downsizings by large retailers have freed up retail space and parking lots. A second trend is also freeing up space: the downsizing of existing boxes and the determination by some larger users that they can live with fewer parking spaces on the perimeter of their lots. This change is creating opportunities for certain players: outparcel developers have remained active in the 1031 exchange market, and a bright spot in retail development is the surge in restaurants and service-oriented retail.

Other retail centers simply do not work in the manner originally configured, and the owners want to transform their sites. All these circumstances can lead to redevelopments involving dividing single spaces into multiple spaces, aggregating smaller parcels together, carving out or spinning off portions of a development to third parties, and combinations of any or all of these approaches.

Clients and business partners are generally charged with the task of understanding the business issues and physical hurdles that redevelopments require. Legal concerns may quickly trump these constraints. Municipalities often take an active role in redevelopment; many times, it is their proverbial second bite at the apple to fix perceived issues or force updates to new codes and ordinances. Lenders and existing loan provisions may play a role, especially when the loan has been bundled and the loan servicer may have little connection to the original lender. Existing restrictions affecting the property being redeveloped may need to be revised.

The REA

The most common type of recorded document, though certainly not the only one, that can affect redevelopment is the Reciprocal Easement Agreement or Declaration of Restrictions.

Recorded Restrictions on Development and Use

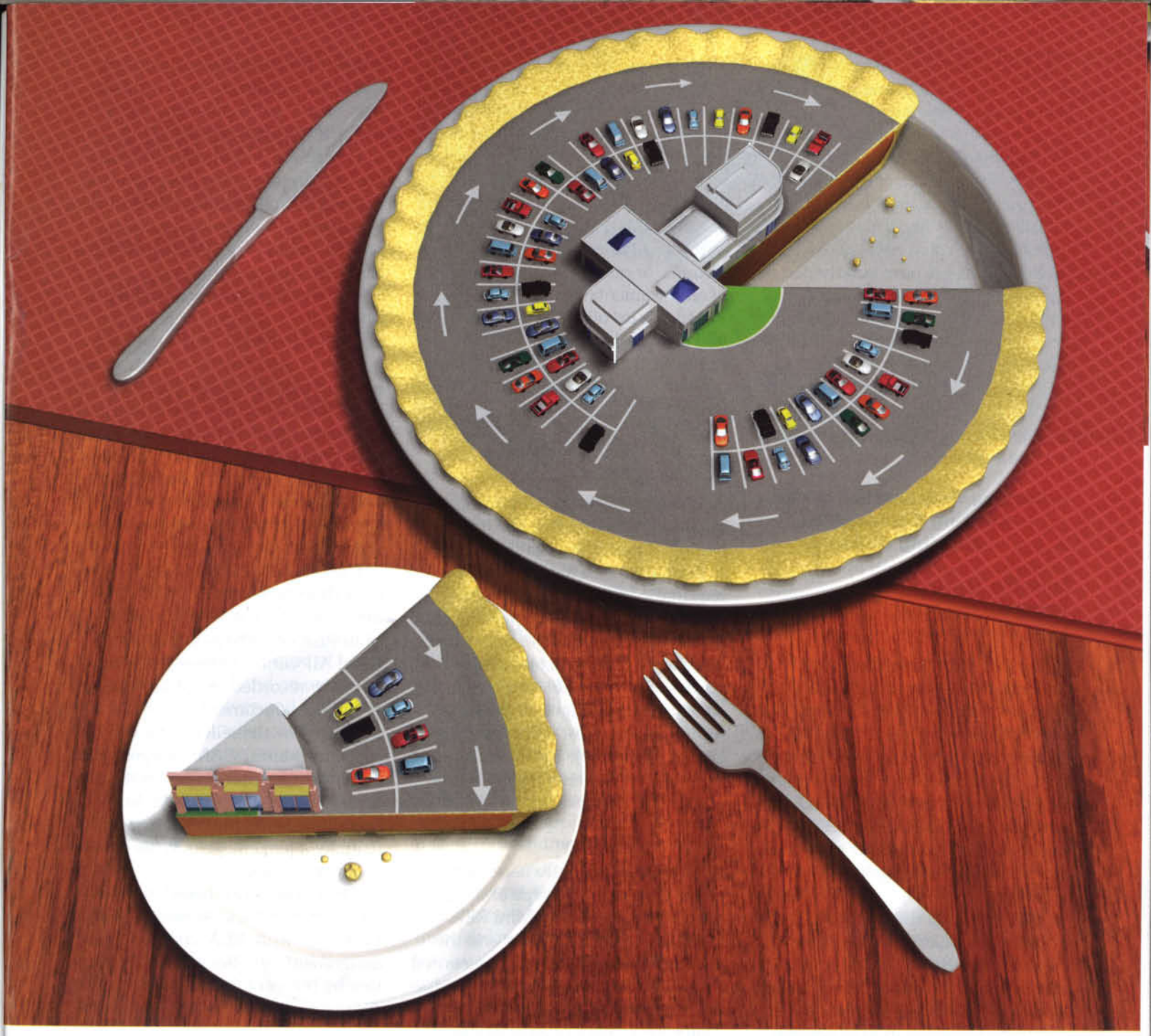
This document goes by many names, to the same effect: Reciprocal Easement Agreement; Construction, Operating and Reciprocal Easement Agreement; Covenants, Conditions and Restrictions; and so on (REA). These instruments have long durations and often certain parties have the option to extend at their expiration. The only structural difference among the documents is a Declaration of Restrictions, which is imposed by a single owner before development of a larger tract, whereas the others typically have multiple parties at the inception of the agreement. Long-term ground leases can play the same role as an REA in some cases, and subleases and even sub-subleases may be controlling documents.

Effect of REAs on Outparcel and Perimeter Parcels

These documents touch many aspects of proposed outparcel and perimeter development. They address easements for parking; ingress/egress to public rights-of-way, other parcels, or other common facilities such as utility facilities, signage, or other amenities; utilities; and drainage. Construction issues will be covered, such as plan approvals, architectural controls, blackout periods, permissible building areas, staging areas, bonds, and mechanic's liens. Common area maintenance provisions address who is

Kathleen Dempsey Boyle is a partner with Meltzer, Purtill & Stelle LLC in Chicago, Illinois. **Cristina Hendrick Stroh** is senior counsel—real estate legal for JCPenney in Plano, Texas. **Benno G. Rothschild** is a partner with Hartman Simons & Wood LLP in Atlanta, Georgia.

Andy Dorsett



responsible for performance and to what standards, cost sharing, and self-help or takeover rights. General restrictions provisions will cover issues such as permitted and prohibited uses and limitations on building heights. An REA typically requires each parcel owner to pay the real estate taxes for its parcel but may address taxes in other ways. Opening or operating covenants may be contained in this document, including the recapture or buyback rights of the developer. Signage provisions are often quite detailed. Insurance and indemnity provisions will describe what types and amounts of insurance are required, and the damage and destruction provisions will set forth under what circumstances the parties must rebuild or raze damaged improvements. Especially important in this context are the sale and transfer provisions that address the rights and obligations of each party (particularly the anchor stores) when they transfer their properties. Finally, survival provisions will address whether certain easements survive termination or expiration of the REA (parking rights or use restrictions may expire when the REA expires or terminates).

Should the Parties Amend, Restate, or Supplement an REA?

During a redevelopment, it will be necessary to address the REA. This will depend on several factors, including the level of change contemplated (a major redevelopment might necessitate a restatement of the REA rather than an amendment), the age

of the REA (and how many of the provisions are stale), and how many times it has been amended before, because many amendments can make the document difficult to interpret and a restatement can be used to reset and prevent inconsistencies. Other factors that may necessitate updates include parties that have exited, property that has been subdivided or eliminated from the shopping center described in the original REA, or new property to be added. If multiple REAs can be updated, consolidated, or terminated, that should be considered as well. For smaller changes, an unrecorded supplemental agreement may be sufficient.

Carving Outparcels from an Existing Center with Existing REAs

From the Tenant/Buyer Perspective—Due Diligence to Be Conducted

A new outparcel purchaser may not understand the ramifications and need for approvals from REA parties. Consent may be needed for a sale or only for new permissible building areas. It can be cost-prohibitive for a new developer, owner, or user if an amendment to the REA is needed, depending on the number of parties, site plans or renderings needed, and legal fees.

The seller will usually be the party with the relationships with other parties to the REA. The seller may simply make introductions to facilitate approvals or might take on the drafting and negotiation of consent documents. It is important to address representations and warranties from the seller in the purchase and sale agreement for approvals by other REA parties, permitted use, zoning, and related issues so that it is clear what role each party is taking in the process.

During the title and survey review, the buyer needs to review REA site plans in detail. Look for drive-throughs, height restrictions, or curb cuts and access because they will affect the planned development. Use, height, and other restrictions are often in leases, not recorded REAs, so the buyer should check memoranda of lease. Deeds in the chain of title should also be checked for any restrictions. An evaluation should be made of what is in the immediate vicinity that may affect property or that raises questions (such as an airport, rail lines, transit stops, gas stations, or other potential sources of environmental contamination). If a lender is involved, a partial release will be necessary.

For further information, see the due diligence checklist at the end of the article.

Anchor Store as Outparcel Developer/Seller

Anchors often own their parcel, including parking. Possible mothballing of part of a store (reduction in floor area) or a reduction in the required parking ratio in the shopping center may free up parking for development. An anchor may horse-trade approvals with other REA parties for permissible building area, parking ratio changes, or parking reconfiguration (for a drive-through lane, for example), additional signage, or other details related to the outparcel development.

Necessary Documentation

Several documents are necessary in connection with this type of development. The first is a "Mini REA" between the anchor/seller and the outparcel buyer that is to be recorded in the real property records. This document acknowledges a shopping center REA, fills in easement gaps that may exist after the expiration of the center-wide REA, provides reciprocal easements internal to the anchor parcel that is being divided (access, utilities, parking, signage), and addresses cost sharing for the maintenance of such easement areas and remedies for nonpayment thereof. Perhaps most importantly, this document includes protections for the buyer as to the anchor/seller's right to approve amendments to a center-wide REA that could adversely affect the buyer's development (signage, parking, ring road alignment, increase of CAM charges) and preserves the anchor/seller's rights as the "Major" or "Approving Party" under the center-wide REA.

If multiple outparcels are carved out of a single anchor parcel, the parties may have to amend the Mini REA to contemplate three or more total parties, rather than stacking multiple Mini REAs on the property.

The purchaser/developer may be developing for a specific tenant or occupant, in which case the parties need to be sure that any involvement of the tenant is only for the term of its lease. If such tenant is the actual party in interest (such as through sale-leaseback financing or a similar vehicle), it should be addressed that the tenant will make payments or review or approve matters like changes to protected areas.

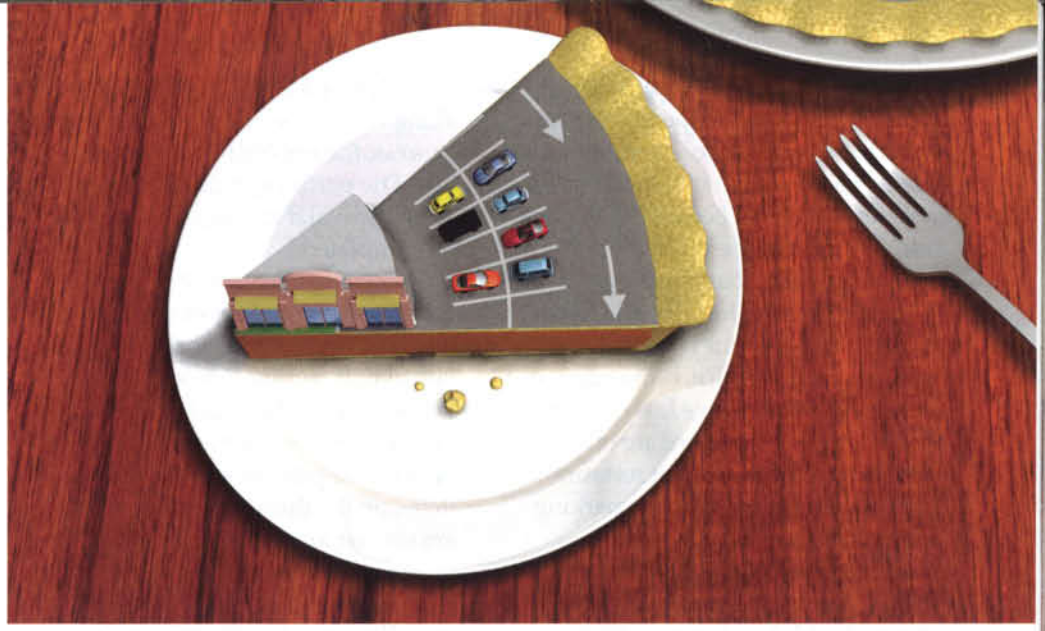
Cost sharing of center-wide REA charges also needs to be documented. This can be done in the Mini REA or perhaps in a separate CAM Allocation Agreement so as not to be recorded in public records. Whichever document is used should provide how the seller's share of costs for exterior CAM charges, taxes, and any other charges under the center-wide REA that will be shared will be split between the seller and buyer (usually a percentage of costs based on square footage).

The parties also should execute an Assignment and Assumption of the center-wide REA, containing an assignment by seller and an assumption by buyer of the REA as to the property conveyed.

Subdivisions: Addressing Recorded and Unrecorded Use Restrictions

Developers with foresight push hard to keep outparcels out of the shopping center definition from the beginning in their leases and REAs to allow more flexibility in subsequent development. The paradigm we are exploring assumes this did not happen, or that land once included as part of the overall shopping center is now being carved out. When land in a defined shopping center is subdivided and ownership is separated, it

A NEW OUTPARCEL PURCHASER MAY NOT UNDERSTAND THE RAMIFICATIONS AND NEED FOR APPROVALS FROM REA PARTIES.



is necessary to confirm whether pre-existing exclusives or prohibited uses remain binding. The buyer or tenant should look for recorded restrictions and controls during due diligence, including memoranda of lease.

A more problematic situation arises when a memorandum of lease was never recorded and an owner fails to take exclusives and restricted uses into account when subdividing or developing an outparcel. The seller must remember to record evidence of any such restrictions before conveyance.

A seller must do its due diligence properly and record restrictions against the new parcel that cover both exclusives and restricted uses in unrecorded leases. Restrictions also should take into account the enforcement burden that may fall more heavily on the seller because its tenant may have remedies for failure to enforce that are different from the restrictive covenant (such as rent abatement). The move toward "Landlord Covenants" in leases over the more common exclusive provisions of the past has only made this issue more important to assess when creating new parcels under different ownership. A buyer should ensure that if a deed restriction is imposed to enforce a lease restriction, any exclusive does not outlast the lease, and any restrictive covenant contained in an unrecorded lease will also terminate with that lease. Unfortunately, sometimes a simple error like leaving an exhibit off of a closing document can spawn litigation.

Redeveloping a Big Box or Creating New Perimeter Development

Former big-box stores can be divided into smaller tenant spaces that anchor a perimeter development, or a store can be razed to create new perimeter development. Various development constraints can result from limitations in REAs or governmental requirements that are applicable to anchor boxes, such as number of entrances, exterior features such as signage and color scheme, the building footprint and changed traffic patterns (drive-through lanes and so on), changes in use (such as to a restaurant) and different parking ratio requirements related thereto, effect on access of other tenants or occupants (depending on the configuration of the carved-up anchor box), and visibility and view corridors. Other practical considerations come into play, such as division or sub-metering of utility lines and potential fire prevention reconfigurations.

The relationship of big and small owners or tenants in perimeter centers will need to be delineated. If there is an REA, the role of the parties to the new development needs to be determined. It may be beneficial to do multiple two-party REA-type documents with various parties: between owners of bigger tenant spaces in the perimeter development, between the developer of the larger center and the owner of the adjacent perimeter center, and between the owner of an adjacent big-box store and perimeter development.

Perimeter REAs may have more detailed requirements than the Mini REA for outparcels discussed above, such as approval of adjacent anchor or junior anchor stores, layers of REAs, the plans review and approval process, and detailed use approval and consent provisions.

Division of an existing box may or may not fit within the existing cost-sharing scheme. Costs need to be allocated among tenants in a perimeter development. The perimeter development also contributes to road maintenance or other common costs within the larger center. In addition, there may be an effect on existing tenants or occupants, changing their allocations. Existing tenants may have protections in their leases precluding or capping application of increases.

Breaking up big-box space such as leasing to junior anchors can lead to different pitfalls. One concern is the scope of subleasing rights and partial recaptures. A landlord should require division of space for subleasing by tenants or for recapture by the landlord to include some storefront area; otherwise the landlord may end up recapturing only tough-to-lease space

in the back of the building. Consider limiting the scope of any right to further divide space. A reconfigured big-box area often has some less desirable tenant spaces because of the size and footprint of the building or the odd size of premises that may be away from the main parking lot. The spaces may make more sense for nonretail uses, such as medical office, brokerages, or education, which have less customer traffic. Parts of the space are often conducive to restaurants, but restaurants are subject to more onerous parking requirements.

Expansion of a big box can lead to different potential issues. Depending on the REA or layers of REAs, the big-box owner may have to seek approvals for expansion of its building or additions to the perimeter. Strip center-type perimeter developments may give strong approval rights to smaller owners. Building footprint alterations, traffic changes, and access point changes may trigger a requirement to amend the REA.

Supplemental REAs and side agreements may be needed to get the deal done, creating layers of REA-type documents. An amendment to the center-wide REA may take too long to complete and kill a deal, or have to be treated as a post-closing matter. Perimeter development and outparcels are subject to the same documentary regime, but two-party REAs or side agreements can address particular issues. Ideally, the owner should focus on maintaining flexibility within the center regarding new development opportunities and avoid giving new tenants or occupants too much power to approve changes to the center.

Perimeter developments may or may not be subdivided from the rest of the center but in any event will require existing lender approval or release.

Making the Lender Happy

When a lender is involved, the first and most obvious issue is whether a release is required. Syndicated loans present special and more complicated problems. The low-interest environment today makes older loans harder to pay down or pay off without significant penalties. If an outparcel was not pre-approved in the loan documents along with a specific release price and process, the negotiation can be arduous. The parties should plan ahead for pre-approval if an outparcel release is contemplated.

Even if no release will be required, development or redevelopment will inevitably be a material change to collateral that requires lender consent. While each lender will have a slightly different protocol for consent, it is still better to be proactive in the process. Items on the due diligence checklist are similar to what a lender will want to see, especially title, survey, site plan, and zoning information. Anticipating a lender's due diligence requests can shortcut a scramble later, especially regarding third-party reports that require lead time.

Permits and Entitlements

Another pitfall in dealing with carving out new parcels, or aggregating existing parcels into an integrated whole, is the permitting and entitlement process.

Permits and Subdivisions

The permit process is usually the first due diligence item to be explored when contemplating any carve-out from an existing development.

A legal subdivision (which also includes aggregating parcels) typically allows affected jurisdictions a new bite at the apple, which may not only affect the subdivided property but also may affect grandfathered regulations on the existing property, such as new stormwater regulations, on- and off-site; upgraded utilities burying overhead lines; changed parking requirements (up or down); ADA compliance; off-site street, sidewalk, or public transportation improvements without public money; upgraded landscaping or lighting; new zoning overlays; new operating requirements (outdoor storage, delivery hours, and so on); or direct access points from public streets without the ability to use an easement access.

Re-plats and other governmental processes are time-consuming, and even if successful, the time expended can kill the deal that prompted the original idea. Sometimes jurisdictions may want to examine private easements such as the REA or Mini REA as part of this process to determine if they sufficiently meet operational standards.

Aggregation of Parcels

Aggregation of parcels can create different issues. Sometimes increasing parcel size triggers different development or zoning rules. Combined parcels may lose signage or access opportunities available to separate parcels. Increasing parcel size can affect stormwater regulations, including obligations for on-site detention or retention. Regulations can differ based on parcel size because of a perception of larger effect, even if merely combining existing developed parcels. If a lender is involved, it may require that rights on the new property be added to ensure the value of its existing collateral.

Using Municipal Requirements to Simplify REAs

Sometimes municipal requirements could simplify REA revisions because they cover the same issues. Parking and signage are two obvious examples. If the ordinance subsequently changes, original changes may be grandfathered, but subsequent phases or future redevelopment could be affected.

Conclusion

Outparcel and perimeter development requires patience and perseverance, and early and thorough due diligence is key. Each step of the development process may take longer than expected, and timelines may be measured in months, not weeks. Outparcel developers will engage in significant negotiations with other interested parties, including lenders and municipalities. When working through deal terms, remember the lessons of past developments, and strive to maintain flexibility for the property going forward. Avoid use restrictions that may become obsolete or that unduly encumber the property, and consider that simple agreements may be sufficient. Matters that were addressed in REAs of the past may now be handled by zoning or other governmental restrictions, thereby simplifying any private agreements for the outparcel or perimeter development. ■