The ABCs of Redeveloping Existing Shopping Centers

By John I. Cadwallader and James B. Jordan

American shopping centers are in a continual state of evolution, first transforming from strip malls to indoor shopping malls, then to modern "power centers" containing only big-box stores occupied by national tenants, then to "lifestyle centers." Redevelopment of existing shopping centers raises a number of issues for the real estate practitioner, which are discussed in this article along with perspectives on how to address those issues.

A typical redevelopment transaction consists of the construction or renovation of one or more buildings in an existing project, with or without the demolition of existing buildings, and often includes the reworking of existing access, parking, and signage. Such physical reconfiguration often requires a restructuring of the ownership and modification of the project's real estate documentation, because it is customary for portions of the shopping center to be owned by different parties. For example, anchor tenants often own or ground lease their buildings or parcels. Consequently, a restructuring can require conveyances of fee title that include mortgage releases, either new or modified reciprocal easement agreements with mortgage subordinations, and perhaps lease terminations and lease amendments. Regardless of the nature of a proposed redevelopment, careful planning by counsel is required to complete a redevelopment transaction successfully. Counsel must carefully review all existing documentation, which is likely to be complex and involve multiple parties, and must evaluate each step in the legal process to determine whether problems exist.

The following commentary will focus on different types of redevelopment, the reasons for redeveloping shopping centers, the types of financing available and their effect on a planned redevelopment, common issues and impediments to redevelopment transactions, and special issues posed by redevelopment when existing tenants continue in operation.

Types of Redevelopment

From a conceptual perspective, there are two kinds of shopping center redevelopments. The first kind, which is the simpler approach, is the redevelopment of a project with no change in the real estate product type. A common example of this occurs when an enclosed mall is redeveloped but still remains an enclosed mall after the redevelopment. The second kind of redevelopment results in a change in the real estate product type or the creation of a new product type. Examples of this latter sort of redevelopment include adding a external lifestyle center component to an existing project, "de-malling" to convert an enclosed mall into an open air shopping center, often with different types of tenants, or perhaps adding a "big-box tenant," such as a discount department store or home improvement store, as a replacement for a traditional fashion department store anchor. This type of redevelopment is more complicated because the existing ownership and real estate documentation often are not flexible enough to accommodate these physical changes.

Reasons for Redevelopment

Existing shopping centers are redeveloped for a variety of reasons. One common reason is the closure of an anchor tenant caused either by consolidation or by the tenant's going out of business or into bankruptcy. There has been an extraordinary consolidation of anchor tenants over the last 10 years. See Diana Mirel, Redefining the Anchor Tenant: IREM Members and Retail Professionals Provide Insight, J. Prop. Mgmt. (Jan./Feb. 2008) (Special Report), at
In many cases, this consolidation has resulted in one department store operator of multiple anchor stores in the same mall. As a consequence, the department store operator often closes one or more of the duplicative stores.

In addition to anchor tenant closure, investment of new capital has been in the past a recurring reason for redevelopment. For example, a shopping center owner or purchaser may want to invest in the upgrade of a well-located but tired project to create a more valuable property. Similarly, a change in demand patterns may result in a desire for new product types, such as open air lifestyle centers or power centers, providing the impetus for redevelopment. Finally, occupancy problems with "in line" tenant space can be the catalyst to "de-mall" an enclosed mall and convert it to an open air power center.

Financing of Redevelopment

The typical redevelopment transaction is a very capital intensive undertaking, often requiring substantial new funds, including debt and equity. Current challenges in the capital markets make it difficult to finance any retail project, not to mention a complicated redevelopment transaction. Nevertheless, once the credit crunch eases and capital begins to flow again, redevelopment transactions will likely become commonplace again.

This article will highlight several types of financing for redevelopment: state and local incentives and public-private partnerships, securitized or commercial mortgage-backed securities financing, and conventional financing or portfolio loans.

State and Local Incentives/Public-Private Partnerships

A variety of governmental incentive programs exist to encourage redevelopment projects. One such incentive, called tax increment financing (TIF), is a financing arrangement enabled by state legislation to attract private investors and to finance redevelopment projects in blighted or rundown areas. Essentially, a TIF makes use of the increased taxes (the "tax increment") arising from increased assessed value because of redevelopment to provide funding for necessary infrastructure improvements or other incentives. Under a typical TIF arrangement, a locality first issues tax increment bonds, the proceeds of which are used to generate the necessary cash to provide developers with incentives to undertake the redevelopment. The incentives vary depending on the TIF law and can include the sale of property on favorable terms, cash incentive payments to the developer, or providing infrastructure improvements at government cost. Once the area is redeveloped, property values will likely increase, and the tax increments are used, at least in part, to pay the interest on the bonds. In the case of a TIF, taxes do not increase other than by virtue of the increased assessed value.

Improvement districts—sometimes called "community development districts" (CDDs), "community improvement districts" (CIDs), or "municipal improvement districts" (MIDs)—are alternative local incentive programs that involve financing similar, but not identical, to TIF programs. In a typical improvement district, a specific governmental authority is created to tax property within the district and to use these tax proceeds to construct infrastructure improvements such as parking decks, retention ponds, roads, parking lots, and other enhancements. Bonds are often issued by this taxing authority, and improvement district assessments or fees are used to pay the improvement district bond debt service. Improvement districts also can be created to generate funds for services that benefit the project, such as security, shuttle bus services, beautification of streetscapes, and so on. Unlike TIF arrangements, improvement district financing usually involves increased taxes.
In the present economy, of course, a cautionary note is in order. Many local government authorities are suffering financial problems, and efforts are being undertaken to cap or limit increases to homeowners’ taxes. These problems may render state and local incentives less productive until the economy improves.

Existing Financing and the Redevelopment of the Shopping Center

To the extent the shopping center is security for an existing loan, the owner typically will be required to obtain consent from the holder of the loan for the proposed redevelopment. Commercial real estate loans are generally broken down into two basic categories: loans that are securitized (“CMBS loans”) and portfolio loans. Portfolio loans are originated by a lender, such as a life insurance company or other financial institution and held on its balance sheet through maturity. In a securitized loan transaction, after the loan is originated, the loan is sold by the original lender and transferred to a “pool” along with up to thousands of other mortgage loans, as discussed in further detail below.

Shopping centers have been one of the primary collateral types that have benefited from CMBS loans. Although the current credit crisis has virtually eliminated CMBS loans as a practical source of funding for owners of commercial properties, many existing shopping centers poised for redevelopment are subject to existing CMBS loans. Notwithstanding the current state of the capital markets, many in the financial world (or what is left of it) believe in the long-term viability of CMBS loans. Given the number of loans that have been previously securitized, and the expected return of the CMBS market, it is important that owners of shopping centers understand the restrictions contained in CMBS loans and how these restrictions could affect the redevelopment of their shopping centers.

Securitization is the pooling of cash flow-producing assets (such as commercial mortgage loans), followed by the issuance of securities backed by those assets. Securities that are secured by an interest in the pool of commercial mortgage loans are commonly referred to as commercial mortgage-backed securities. Once the loans have been transferred to the mortgage pool, the day-to-day administration of the mortgage loans is handled by the “servicer” of the mortgage pool. The servicer performs the routine tasks that comprise the servicing of the loans in its pool, such as collection of the monthly payments, collection and disbursement of escrow funds, review and approval of leases, and, when necessary, any minor modifications of the loans. For performing loans, servicing of the loans is undertaken by a "primary" or "master" servicer. For nonperforming loans, or loans for which a default is reasonably foreseeable, the servicing is handled by a "special" servicer.

Typically the pools of mortgages are held by a grantor trust, and the trust will elect to be treated for tax purposes as a real estate mortgage investment conduit (REMIC). So long as the REMIC trust complies with the restrictions set forth in the Internal Revenue Code and Treasury Regulations, it will be treated as a pass-through entity for federal income tax purposes.

CMBS loans have both advantages and disadvantages. On the one hand, securitized lending provides cheaper loans, lower interest rates, and more streamlined and simpler closing processes. On the other hand, the administration of securitized loans can present logistical and geographic dilemmas for the borrower. Typically, once the loan has closed, the party with whom the owner dealt does not have responsibility for the loan. Instead, the loan is administered by a servicer, which is often located at a different place and with whom the borrower often has no existing or established relationship.

For an owner whose loan has been placed in a CMBS pool, two typical limitations can affect the borrower’s ability to redevelop its mortgaged shopping center. First, CMBS loan documents typically prohibit, or severely limit, the borrower’s ability to incur additional debt, whether or not the additional debt
is secured by the mortgaged property. Unless the right to obtain additional financing is negotiated by the borrower at the time of the original loan closing, the servicer of the CMBS loan will not typically consent to the borrower's obtaining additional financing. As subordinate or mezzanine financing is often the primary source of the funds necessary to pay for the redevelopment of a shopping center, this restriction often has a major effect on the proposed transaction.

Second, CMBS loan documents typically prohibit or severely limit the borrower's ability to modify the existing collateral for the loan. A major physical change in the shopping center, such as the demolition that may be needed for a redevelopment, would be considered a modification of the collateral, and a consent by the holder of a CMBS loan to a major physical change would be deemed a modification of the existing loan documents. A REMIC is not permitted to modify a loan if the modification would be deemed "significant" under the Internal Revenue Code and Treasury Regulations. A modification that "releases, substitutes, adds or otherwise alters the collateral for, a guarantee on, or other form of credit enhancement for a recourse debt instrument" is deemed a significant modification of the loan. Treas. Reg. § 1.1001-3(e)(4)(iv)(B). Unfortunately, although the Treasury Regulations speak in terms of modifications affecting a "substantial amount" of the collateral, the Regulations do not provide guidance about what constitutes a "substantial amount." The demolition or release of 10% or less of the collateral currently securing the loan is generally thought by tax practitioners not to constitute a substantial amount of collateral; however, there is no uniform approach to this determination. If the lender's consent to the proposed redevelopment would be deemed a significant modification of the CMBS loan, the servicer of the loan will not be willing to consent to the transaction. This restriction can limit the borrower's ability to redevelop an existing shopping center, particularly when the proposed redevelopment would require the demolition of a substantial portion of the improvements forming the collateral for the loan.

If it is likely that the shopping center will be redeveloped during the term of a CMBS loan, the borrower should specifically contemplate the redevelopment in the CMBS loan documents. Absent specific language in the CMBS loan documents that permits the redevelopment, a borrower will often find it necessary to pay off the existing loan and obtain new financing.

Conventional Financing/Portfolio Loans

Considering the issues raised by securitized financing, it may be more prudent to use conventional financing for a future redevelopment candidate. Regardless of the choice between conventional or securitized financing, however, when redevelopment is contemplated, it is incumbent on counsel to plan in detail each step of the restructuring process (for example, release of collateral, modification or termination of reciprocal easement agreements and operating agreements, lease modifications and terminations, and so on). Provisions must be included in the loan documents that permit each such step to be undertaken.

Issues and Impediments in Redevelopment.

In addition to the issues raised by financing, various restrictions and other limiting agreements that affect the property must be addressed by an owner that is redeveloping an existing shopping center. If any of these restrictions or limiting agreements are relevant, consents from multiple parties (and their lenders) may be required.

Repurchase Rights/Rights of First Refusal

Many existing mall reciprocal easement agreements (REAs) or other documentation, which were often negotiated at times when the anchor tenants had substantial leverage, may contain provisions granting
certain existing or former tenants the rights to repurchase parcels or rights of first refusal. The mall owner must comply with these provisions or have them waived before conveying parcels as part of a redevelopment transaction. Counsel for the redeveloping owner should carefully examine the existing title insurance policy and obtain an update at the outset to avoid unpleasant surprises about these title matters.

**Operating Covenants**

Operating covenants, while relatively uncommon in power centers, are much more prevalent in the other types of shopping malls given the concession packages often made available to anchor tenants. Typically, each tenant's operating covenant is made contingent on all the other anchor tenants having similar operating covenants and not being released from those obligations.

This may pose a problem when a particular anchor tenant is released from its operating covenant to permit the redevelopment of its building. In such event, the release of the anchor tenant being replaced can result in the release of all other operating covenants in the shopping center.

**Use Restrictions**

Traditional mall leases and REAs commonly contain prohibited use restrictions, some of which could inadvertently preclude the proposed redeveloped shopping center from including additional product types. For instance, there may be restrictions on outdoor sales, which would be problematic for a home improvement retailer. In addition, language that originally seemed innocuous, such as a prohibition against a tenant that is not a "first class enclosed mall type tenant," could complicate the introduction of a new product type, such as a discount department store or a warehouse club.

**Requirement That an Entrance to the Interior Mall Be Maintained**

Enclosed mall REAs frequently require that all anchor stores be connected to the interior mall by means of a direct entrance. Anchor tenants typically desire this arrangement because it results in additional "cross shopping" (that is, customers coming to the mall to shop at a particular store will also shop at other stores during their visits). This approach is inconsistent, however, with the typical store planning of a big-box retailer such as a discount department store or home improvement store. These big-box stores are not accustomed to having more than one customer entrance and will likely resist the operational changes that would result from multiple points of connection.

**Permitted Building Areas**

Existing REAs commonly restrict the areas in which buildings can be located. If these agreements do not accommodate for expansion or relocation of buildings, it may be difficult to redevelop the shopping center to modify building locations.

**Height Restrictions**

Similarly, existing REAs may impose height restrictions that prohibit redevelopments.
Frozen Site Plan

Many REAs provide for a “frozen site plan” (for example, “the shopping center shall be developed and maintained in accordance with the site plan attached as Exhibit _”). This type of covenant precludes redevelopments that result in changed site plans.

Parking Restrictions

One final consideration often posed in redevelopment transactions arises from parking restrictions. Many mall REAs require an overall parking ratio for the entire mall and also demand that each individual parcel maintain its own required parking ratio. This restriction may be problematic if the parking areas of the shopping center are moved or adjusted so that the total number of parking spaces is not decreased, but the allocation of parking spaces among the various parcels is modified in an impermissible manner. Moreover, deck parking, which is commonplace in many enclosed regional malls, is less common in the open air, and many traditional power center tenants may not look favorably on deck parking arrangements.

Special Issues Posed by Redevelopment When Tenants Remain in Operation

When considering redevelopment, a significant threshold question is whether existing tenants will cease operating or remain open. Many tenants will resist any suggestion that they cease operating because closing will cause them to lose business, and it may be difficult to re-establish their customer base when the center reopens. If a tenant does in fact decide to close, the owner must consider whether this closure will affect the cotenancy rights of other tenants in the shopping center. These cotenancy rights permit tenants to pay reduced rent or terminate their leases if certain occupancy levels are not maintained.

If tenants decide to remain open, the owner may encounter a variety of problems in redeveloping a shopping center around these operating tenants. For example, the owner will need to think generally of the problems that will result from the operation of a store in a construction zone. These problems can include the need to provide asbestos remediation safety measures, safe access to and from the store, convenient parking that meets required parking ratios, signage to permit customers to find their way to operating stores, dust, dirt, noise, and the loss of customers that can result from the inconvenience of operating amid construction. These challenges raise questions regarding the rights of operating tenants and the legal causes of action available to them.

Express lease provisions address many of these issues. Even if they do not, the warranty of quiet enjoyment can provide a cause of action to an operating tenant if the landlord's construction activities during redevelopment interfere with or disrupt the tenant's business. At common law, this warranty protected tenants from actual dispossession from the leased premises resulting from actions of the landlord or a third party claiming title superior to the rights claimed by the landlord. A limited number of jurisdictions, New York and Georgia included, still restrict the covenant to "possessory" protection, maintaining that a tenant must—at a minimum—prove constructive eviction to recover damages for breach of the warranty of quiet enjoyment. See, e.g., Hardwick, Cook & Co. v. 3379 Peachtree, Ltd., 363 S.E.2d 31 (Ga. Ct. App. 1988); Reade v. Reva Holding Corp., 818 N.Y.S.2d 9 (N.Y. App. Div 2006). In a growing number of jurisdictions, however, the covenant of quiet enjoyment, which may be implied or express, includes protection from any "substantial interference" with the tenant's possession of the premises, even if the interference does not rise to the level of constructive eviction and cause the actual abandonment of the premises. See, e.g., Andrews v. Mobile Aire Es- totes, 22 Cal. Rptr. 3d 832, 839 (Ct. App. 2005); Echo Consulting Serv., Inc. v. North Conway Bank, 669 A.2d 227, 229 (N.H. 1995). Regardless of jurisdiction, an owner contemplating future redevelopment activities should include
provisions in the lease documents granting it the right to make the changes required in connection with a future redevelopment. For example, a landlord should include provisions addressing construction disruptions, access issues, and temporary signage. If well drafted, provisions such as these should guard against a claim that the warranty of quiet enjoyment has been breached.

A relocation right is another very valuable tool that the shopping center owner should include in every lease, particularly if a redevelopment is in the offing. Relocation provisions often give the owner the right to relocate a tenant to a “similar” or “substantially similar” space. The negotiation of these provisions often addresses the tenant's concern that its space be in a certain proximity to other areas in the shopping center, such as the food court, entrance to the mall, other anchor tenants, and so on. Nevertheless, a relocation right that is heavily conditioned in favor of the tenant is better than no relocation right at all, because the landlord can choose whether or not to exercise the right.

In circumstances in which relocation rights are not available and an existing tenant needs to be moved to permit the redevelopment, a lease buyout may be necessary. This can be very expensive, particularly if that tenant is difficult to deal with and aggressive in its negotiations. To avoid other tenants’ learning of the landlord’s generosity, the documentation should contain a confidentiality provision. Furthermore, if multiple buyouts are required, the documentation should be signed in advance, contingent on the completion of all redevelopment transactions, a contingency to be exercised and controlled by the landlord.

Conclusion

A wide variety of issues should be carefully considered when planning for the redevelopment of an existing shopping center. Well in advance of the planned redevelopment and before obtaining financing, counsel for an owner planning a redevelopment should carefully lay out each step of the transaction to determine whether any impediments to the planned transaction exist and, if impediments do exist, formulate a plan for addressing and resolving them. The examination of these various concerns and perspectives will provide a framework for the efficient consummation of a redevelopment transaction.

James B. Jordan is a partner in the Atlanta, Georgia, office of Sutherland Asbill & Brennan LLP. John I. Cadwallader is a member in the Columbus, Ohio, office of Frost Brown Todd LLC.