Leasing Considerations in Redevelopment Projects

Tandy C. Patrick, *Bingham Greenebaum Doll LLP*, Louisville, KY

I. Overview

The traditional shopping center came into prominence in the 1960's; many baby boomers have vivid memories of their first visit to the brand new "indoor mall." Now, sixty years later, owners, operators and tenants of shopping centers continue to address challenges with the revitalization of existing shopping centers, with the end goal of ensuring that the shopping center is vibrant, competitive and sustainable and meets the public needs.

"Redevelopment" commonly refers to construction and/or renovation of one or more buildings in an existing shopping center; it may involve demolition of existing buildings, and usually includes reconfiguration of existing access, parking, and signage; and it may involve restructuring of ownership/financing. "Repositioning" commonly refers to changing a brand's status in comparison to that of competing brands; changing the tenant mix in response to changes in the market place; and relocating an existing tenant in the shopping center to a more prominent location (e.g., moving from in-line to an outparcel or moving from "elbow" in-line to end of access drive).

As the costs of land, labor and construction rise, more developers are focusing on upgrades to existing properties instead of pursuing ground-up developments. Today's retail centers are increasingly focusing on providing consumers with experiences they cannot get elsewhere. Millennials are spending more money on experiences than luxury products, driven in part by mobile lifestyles and technology, as well as shifting values in observing previous generations struggle with economic downturn from the previous decade. Adding density by offering residences or hotels is an attractive option for many shopping center owners. Consumers are also moving towards urbanization, living in smaller spaces with a desire to be close to restaurants, entertainment and public spaces in which to socialize and congregate.

Innovative mall operators who are experiencing a successful redevelopment are often undertaking one or more of the following:

1) Incorporating community-based elements, such as concerts, arts centers, spas and fitness centers, farmer's markets, and children's playgrounds;

2) Leveraging technology using social media, proprietary apps, loyalty programs, and customized offers. Technology also provides tools for shoppers such as identifying available parking spaces and purchasing movie tickets; and

3) Changing the design to a town center/open air concept.

Today's new lease documents are likely to include flexibility regarding the types of users (including office, residential, and medical), parking, construction/height restrictions, and different allocations of CAM charges based on the type of user (i.e., retail tenants do not want to be responsible for costs associated solely with the residential or office component of the development). The purpose of this Article is to address practical issues in dealing with existing traditional commercial leases when there are dramatic changes to the property's original site plan and overall design.

II. Specific Lease Issues

Some key lease provisions that are frequently amended and renegotiated in a redevelopment include the following:

(A) Operating Covenants and Co-Tenancy Requirements

In retail leases, the tenant's requirement to continuously operate is often conditioned upon a certain percentage of stores and/or anchor tenants remaining open. Landlords are likely to need more flexibility on replacements for anchor tenants, and will likely seek to replace "national department store" with "quality replacement users", as well as utilizing pop-up retailers, supermarkets, health clubs, theaters and restaurants to satisfy co-tenancy requirements. Landlords may require smaller tenants to prove a loss in sales by the vacancy of an anchor tenant in order to trigger co-tenancy provisions of the lease.

(B) Use Restrictions/Exclusives

In a redevelopment, if the GLA of the retail portion will decrease, a landlord may be more willing to grant exclusive uses, although the landlord may desire to keep a tighter control on the mix of uses and not share control with tenants. The goal of a redevelopment will likely include the incorporation of compatible retail to compliment consumers' needs and lifestyles rather than trying to attract retail shoppers. Typical preferred retail tenants in a redevelopment include restaurants, wellness and beauty services, dry cleaning and fitness centers, as well as medical offices. If a redevelopment includes an office component, the office user may require certain amenities such as a fitness center that office workers can attend.

Existing retail leases may include exclusives restrictions that are overly broad with respect to the scope of the tenant's use (e.g., prohibiting any "pizza restaurant" instead of prohibiting a restaurant serving "fast fired, fast-casual, create-your-own, assembly-line-type, quick-service pizza"). Landlords are now seeking to limit the scope of the exclusive to the tenant's "primary use" (i.e., core business), which may change during the term of the lease. Also, in a redevelopment the landlord may elect to limit exclusives to a specified portion of the project.

(C) Relocation/Construction

Unless the existing lease specifically grants the landlord the right to relocate a tenant's premises, if the landlord needs to relocate tenants to accomplish the redevelopment, the landlord will likely need to offer some concessions to the tenant (i.e., compensation; payment of moving expenses; rent concessions; tenant improvement allowance). If the lease does include a relocation clause, the relocated premises may be required to have the same access, visibility, parking and frontage. Ideally for retail tenants, there is no gap period during which the store is closed (i.e., close on Friday at old location and reopen on Saturday in the new premises). Timing is critical: an accounting office would not be willing to relocate during January through April, and retailers customarily black-out November and December for any disruptions. During construction periods, it is important for tenants to have adequate signage directing shoppers to their new location, as well as having adequate and tasteful screening of the construction site.

(D) Rent Restructuring

CAM charges often need to be restructured in a redevelopment, to accommodate a "town center" that includes community space or to integrate office and/or residential use with existing retail; a redevelopment may involve the incorporation of a condominium regime as a portion of the project. In retail leases, Landlords may also elect to move a greater portion of the rent to percentage rent, with possible revisions to the definition of gross sales and reporting requirements.

(E) Maintenance/Repair

The scope of the tenant's responsibilities may need to be revised to reflect changes in infrastructure and mechanical components following the redevelopment.

(F) Unused TI Allowances

Any unused tenant improvement allowances will likely need to be addressed in an amendment to the existing lease.

(G) Signage Rights (pylon/monument, directory, directional)

Existing tenants may need to consent to dramatic changes in signage in connection with the redevelopment; the responsibility and cost of new signage is often a negotiated issue.

(H) Quiet Enjoyment

The addition of non-retail users (i.e., residential, office tenants) may trigger quiet enjoyment clauses in existing leases where users raise nuisance issues. Retail construction and late-hour entertainment venues can be problematic for an apartment or office user.

(I) Termination Rights

Existing leases may give the tenant the right to terminate the lease prior to the stated expiration date in the event of dramatic changes that arguably have a negative impact on access and/or visibility to the tenant's premises or that significantly change the tenant mix and uses.

III. Recent Court Decisions involving existing lease provisions vis-a-vis redevelopment

(A) *Lord & Taylor, LLC v. White Flint, L.P. (780 F.3d 211, 4th Cir, 2015).*

Lord & Taylor operated a store at the White Flint Shopping Center in Kensington, Maryland for over 38 years, and was an anchor of the center. A 1975 agreement required the landlord to maintain the Rockville Pike Property as a "first-class" mall until at least 2042. The Shopping Center started to decline in the late 1990's and many stores closed. In 2009, the landlord began negotiating with shop owners to close their stores to enable the landlord to redevelop the property, and spent at least $14MM buying out tenants.

The landlord obtained governmental approvals of plans for redevelopment of the center in 2012, which redevelopment included 1 million square feet of office space, 2,400 residential units, 1 million square feet of retail space and a 280,000 square foot hotel. Eventually Lord & Taylor was the only remaining open store at the center. Lord & Taylor filed a lawsuit against the landlord for breach of the covenant to maintain the property as a shopping mall, and a 2015 jury verdict which was upheld awarded $31MM to Lord & Taylor to compensate the store for lost profits and future construction costs that would be necessitated by the landlord's decision to demolish the shopping mall. The White Flint Lord & Taylor store remains open today.

(B) *Wallington Plaza v. Taher (2011WL 2637199, New Jersey 2011).*

A jewelry store tenant in a small shopping center in Wallington, New Jersey vacated the premises and defaulted on rent payments six months prior to the expiration of the 10-year term of the lease, and the landlord sued the tenant and its personal guarantors for unpaid rent and CAM charges. The tenant noted that when it entered into the lease, it relied on the shopping center manager's assurances that the center would be a "first class place to do business"; but in recent years, the shopping center's parking lot fell into a state of disrepair, and many other stores closed (including a Rite Aid drug store, a West Coast video, a Dollar Store, an A&P grocery store, and a Hallmark card store).

The court determined that the landlord breached its implied covenant to operate a "first-class" shopping center, and also noted that the landlord failed to attempt to mitigate its damages by attempting to re-let the premises after the tenant vacated. However, the court upheld judgment in favor of the landlord for two months' unpaid rent less credit for the security deposit based on the tenant's failure to provide proper notice to the landlord of tenant's intent to vacate.

(C) *Frittelli, Inc. v. 350 North Canon Drive (202 Cal. App 4th 35, 2011).*

A gourmet doughnut shop entered into a lease at a shopping center in Beverly Hills, California in April 2006; the lease included a standard "quiet enjoyment" clause for the benefit of the tenant, but also included a provision that permitted the landlord to remodel the shopping center, which provided for an abatement of tenant's rent in proportion to the extent tenant's use of the premises was impaired in connection with the remodeling.

In September 2008, the landlord commenced construction of renovations to the shopping center. The landlord met with the tenants to discuss the renovation; arranged for temporary signage identifying the tenants; and relocated the awnings of the tenants to the top of the scaffolding along the shopping center's façade. When the tenant complained that there was excess dust and dirt in its premises, the landlord directed its cleaning service to clean each tenant's space daily, and also offered rent concessions to the tenants.

In April 2009, the landlord instituted an eviction action against the tenant for rent payment defaults, and the tenant countered with an action for breach of the lease and negligence by the landlord. The court concluded that the landlord could only be held responsible for "gross negligence" and determined that the landlord's actions coupled with their remedial measures did not constitute "gross negligence" and ruled in favor of the landlord.

(D) *Safeway Ind. V. CESC Plaza Limited Partnership (261 F.Supp.2d 439, 2003).*

The tenant, Safeway Inc., entered into a grocery store lease in 1967 at the Crystal City Plaza Shops in Crystal City, Virginia (a suburb of Washington, D.C.). The Plaza Shops were constructed as an enclosed, retail mall with approximately 40 stores; the Safeway store opens onto the interior of the Plaza Shops.

In 2001, the landlord proposed a $40MM renovation project to transform and revitalize the Plaza Shops. Safeway's lease requires Safeway's consent to the proposed renovations, including removal of the existing parking structure which provides surface level parking. Safeway filed an action in 2002 seeking a declaratory judgment that its withholding of consent to the proposed alteration of the common area was reasonable. The Court noted that "although the question is a close one", Safeway's concerns regarding elimination of the surface parking and shift to underground parking was a reasonable ground for Safeway to withhold consent to the renovations. However, the Court held "in the exercise of its equitable discretion" that it would not issue a permanent injunction regarding the renovations but instead ordered a jury trial on the amount of damages owned to Safeway based on the landlord's breach of the lease.

(E) *Odyssey (III) DBx, LLC v. PNC Bank, NA (2014 WL 2050761).*

PNC Bank made a loan to a developer for $7.72MM in January of 2007 to enable the developer to purchase and redevelop the Northgate Village Shopping Center in Gardendale, Alabama, which would attract new tenants to the Shopping Center. The developer secured a commitment from Publix to build a grocery store in a location presently occupied by Dollar Tree. To facilitate the new Publix store, developer entered into an amendment to its lease with Dollar Tree to build a new location within the Shopping Center. The developer failed to complete the construction of the new Dollar Tree store, and in order to resolve ensuing litigation between the developer and Dollar Tree, developer requested PNC's consent to a second amendment to the Dollar Tree lease. PNC requested changes to the second amendment which were never resolved.

The developer instituted an action against PNC for interference with business relationship, breach of fiduciary duty, and breach of contract arising from PNC's refusal to sign the second amendment to Dollar Tree's lease. The court determined that the developer could pursue claims against PNC based on interference with business relationship and breach of fiduciary duty.