

# Real Estate Review

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- THE IMPACT ON REAL ESTATE OF THE TAX REFORM ACT OF 1976, *Francis J. Grey*
- REAL ESTATE PARTNERSHIPS UNDER THE NEW TAX LAW, *Mark H. Long*
- TAX BREAKS FOR REITS UNDER THE TAX REFORM ACT, *Ted D. Englebrecht and John L. Kramer*
- PREPARING FOR A ZONING AMBUSH, *Nicholas Ordway and William C. Weaver*
- RESCUING SUBSIDIZED HOUSING PROJECTS, *Saul J. Feldman*
- ASSESSING PARTIALLY COMPLETED PROBLEM PROPERTIES, *Marshall G. Kaplan*
- NEGOTIATING THE PURCHASE-MONEY MORTGAGE, *Robert Bell*
- REDUCING THE RISKS IN CONSTRUCTION LENDING, *Joseph B. Tockarszewsky*
- THE PROPOSED UNIFORM LAND TRANSACTIONS ACT, *James E. Murray*
- THE FUTURE OF THE REAL ESTATE INDUSTRY: CHANGING SUPPLY PATTERNS, *John McMahan*
- A NEW ACCOUNTING BURDEN FOR THE REITS, *Scott S. Cowen and Lawrence C. Phillips*
- PEOPLE AND PROPERTY: ALTERATION CLAUSES IN SHOPPING CENTER LEASES, *Emanuel B. Halper*
- TWO-YEAR INDEX

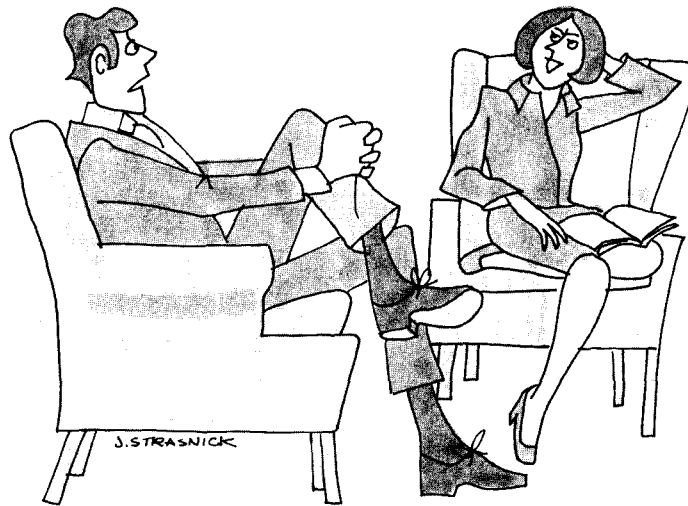


The Real Estate Institute of New York University

*Both landlord and tenant need protection when changes are to be made.*

# People and Property: Alteration Clauses in Shopping Center Leases

*Emanuel B. Halper*



**W**E REAL ESTATE MEN can't win!

Even in normal times, we start our workday early in the morning, and we come home late at night. And what do we get for all of this?

I get arguments from my wife, my daughter, my son, my father, and my father-in-law.

Why aren't you home for supper? You didn't read me a story for 214 days! Who are you? Why didn't you call me?

Why, I ask, don't our families realize that we real estate professionals are absent from our homes so much for only one reason. And that reason is for love of family.

Mrs. Halper: Come on now, don't you think love of money has something to do with it?

I: Don't we need money to pay the mortgage? What about all the bills we get every month from department stores?

Mrs. Halper: Look, you've been leaving the house before 7 A.M. and returning after 10 P.M. five days a week. When you're home, you're con-

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This article is adapted from his forthcoming book, *Shopping Center Leases, What to Look for and Why*, to be published by Warren, Gorham & Lamont.

## People and Property

stantly on the phone with Harry, Big Irving, and Jack. When is it going to end?

I: Soon. Soon. You know I've been working on the Marlan Supermarkets Corp. bankruptcy deals. Since their bankruptcy, they stopped doing business in twenty of Harry's shopping centers. You know how Harry is when some of his stores are vacant.

Mrs. Halper: Look, let's take a vacation now. We'll get away from Harry. Right now!

(Telephone rings.)

Mrs. Halper: It's Harry.

Harry: Listen, kid. We just got the greatest opportunity in history. It's the biggest thing. More than 1,200 department store leases will be on the market. I smell bargains. I want you to read all the leases by Friday.

I: 1,200 leases, Harry? What happened?

Harry: Haven't you heard the latest? Diana Unigrant went under.

I: Diana Unigrant? I can't believe it. They were one of the biggest.

Harry: Look. There's money here. There are bargains to be had. While you read the leases, Irving, Jack, Augie, and Marvin will go out and look at the stores.

I: Harry, my wife and kids are acting up again. My wife insists we go on vacation.

Harry: You just don't know how to handle your wife. Lay the law down. Make her come with you a few days. Let her bring the kids and watch how hard you work.

I: But—

Harry: No buts. You're due in bankruptcy court next week on some of the Marlan Corp. deals. Take the whole family with you. Let them see what it's like to blow a day in bankruptcy court.

I: But—

Harry: No buts.

Since Harry insisted, I convinced my wife and children to spend the following day with me at the federal courthouse in Foley Square in New York.

The courtroom wasn't too crowded that day, but I was surprised to see quite a few other family groups there. Even that crusty old warhorse, Mitchell Gozlen, brought his wife. Or was it his wife? Even Rock Monis came, and look at how many children he has. When Harry walked in with his wife, I was sure I had done the right thing.

We were in court because Harry owned a supermarket in Yennervelt, Mississippi that had been

leased to Marlan. Marlan's trustee was auctioning off Marlan's rights to the lease. As Harry's lawyer, I made an eloquent speech insisting that the tenant was in default under the lease, that the trustee had no right to assign the lease, and that the entire procedure of the bankruptcy court and the Bankruptcy Act itself violated the Fifth Amendment to the U.S. Constitution. This bit of rhetoric earned a round of applause from my wife and children, but the judge denied my motion to dismiss and insisted that the auction take place.

Harry had planned to bid for Marlan's leasehold interest himself but dropped that plan when he heard Rock Monis bid \$25,000 on behalf of Mother's Cubbard, another supermarket chain. Rock proudly placed his 10 percent deposit check in the hand of the court clerk and returned to his seat with a smile of triumph. Harry tiptoed over to Rock, causing a small commotion by stepping on the toes of one of Rock's daughters. Harry proposed a conference.

They struck a bargain quickly. Harry agreed to discontinue his challenge to the court proceedings and allow the lease for the supermarket to be assigned to Mother's Cubbard. Rock agreed that Mother's Cubbard would pay Harry 50 percent more rent than Marlan had been paying.

But now that Rock agreed to pay way more rent, Rock wanted Harry to spend \$100,000 to make alterations and repairs to the supermarket in order to prepare it for occupancy by Mother's Cubbard.

Harry was distressed by the sound of the phrase "\$100,000." He spewed forth with the short, volcanic bursts of emotion to which we, his business family, have become accustomed. Rock Monis was not sympathetic and indicated that he was contemplating the possibility of punching Harry in the mouth.

Since such behavior should certainly be avoided in a U.S. courthouse while little children and the judge are looking, I suggested that the conference be adjourned.

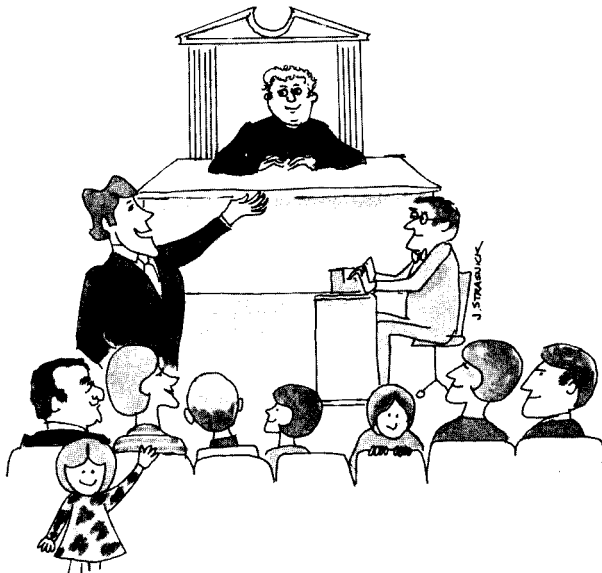
The needs of business dictated another meeting right away. The needs of family togetherness dictated a place where we could be with our families, as well.

That evening, we assembled with our families at the restaurant in the Metropolitan Museum of Art. My wife and Mrs. Monis took the children on a tour of the museum while the lawyers and businessmen sat around a table.

After a number of bitter interchanges, we agreed that the landlord would fix the building's leaky roof. We also agreed on the extent of the initial alterations to be made by the landlord, on the rent, and on the term and use clause. Now Mother's Cubbard demanded the right to make additional alterations to the supermarket building after they took occupancy. And they wanted that right to last throughout the term of the lease.

Harry was afraid that the unlimited right to make alterations would permit the tenant to carve up the premises into many tiny stores or to change things so that the building would be a positively disagreeable place. Rock took the expression of this fear as a personal insult. So Big Irving, Mitchell Gozlen, a museum guard, and I physically separated them.

Mitchell Gozlen suggested that we needed a breather. What's more, he suggested that he and I each prepare a memo to our respective clients on the subject of alterations.



It was Friday night, and the next negotiating session was scheduled for Monday at 4 P.M. That would give us the weekend to dictate the memo and to get it typed on Monday morning. The clients were scheduled to read the memos in the early afternoon so they could eat each other's heart out properly in the late afternoon.

So, on the following morning, I sat down at my desk at home and began to dictate my memo to a tape recorder. After my wife reminded me of our family's determination to be together despite the

exigencies of business, my daughter Eve sat down on my right knee and volunteered to ease my burden by holding the microphone. She was followed by my son Dan, who occupied the left knee and insisted that he could help me by underlining all of my notes.

Thus encumbered, I dictated my memo. Here's a copy so you'll know exactly what I told Harry.

#### PREPARING A STORE FOR OCCUPANCY

A growing number of leases are being made for vacant shopping center buildings. Some of the vacancies arise because first-generation shopping center leases have expired. In addition, the recent epidemic of retail bankruptcies has thrown a great deal of shopping center space on the market unexpectedly.

Before a retail tenant is able to do business from a previously leased store, someone usually must make substantial alterations and repairs. Possibly the business deal can be structured so that the landlord makes no representations concerning the condition of the property, and the tenant agrees to take the building in its present condition. However, the tenant who takes a building in "as is" condition and who expects to make the alterations himself will insist upon paying a much lower rent than he would have been willing to pay if the landlord fixed up the place. Furthermore, a tenant willing to make the necessary repairs and alterations himself often insists that the landlord represent that the building or parts of the building, such as the roof and the heating and the air-conditioning systems, are in good order and repair.

On the other hand, the landlord may have to agree to make the necessary alterations and repairs to the existing building in order to induce a new tenant to occupy the vacant space. For the purposes of the lease, these alterations and repairs should be treated in much the same way as the construction of a building to be leased. Plans and specifications for the work should be set forth in explicit detail and should be made part of the lease. They can be incorporated in the lease by reference and need not be attached as exhibits.

The term of the lease will often depend upon the time of completion of the initial alteration, just as the term of a lease of a building which is being built to a tenant's specifications will usually depend upon the completion of that construction.

Some landlords assume that it is always better if the tenant is required to perform its own alter-

## People and Property

ations. However, I have already indicated that the prospect of a substantial cash outlay at the beginning of a lease term may cause the tenant to insist upon a rental rate much lower than it otherwise might have accepted. The landlord who is willing to make an initial alteration might be in a position to borrow the entire cost of his investment by refinancing his existing mortgage. Spending funds generated by a mortgage made in reliance on the tenant's credit could result in a substantially higher profit than might result if the tenant undertook the work in exchange for a smaller rent.

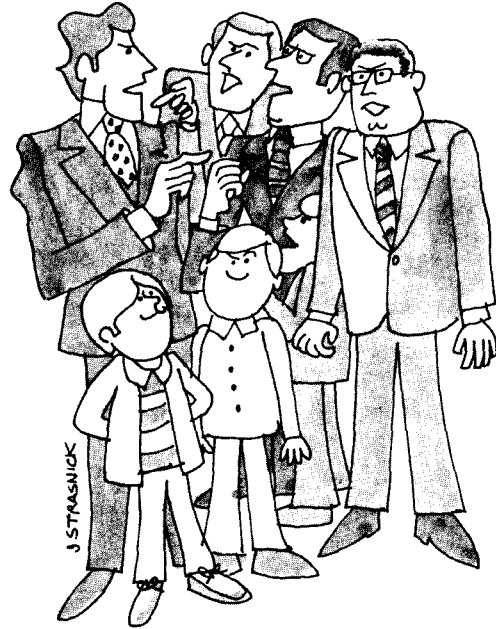
### ALTERATIONS DURING THE TERM

Shopping center buildings can deteriorate in fifteen years or less. Certainly, they may become at least partially obsolete. The retailing industry has been so dynamic and competitive that each year new shopping center buildings are built that exceed earlier buildings in beauty, munificence, and cost. Some museums could be jealous of the appointments of some shopping center enclosed malls.

The retailer who finds himself in an obsolete fifteen-year-old shopping center building competing with Taj Mahal Plaza across the street naturally begins to think about renovating his premises. Even if the retailer is willing to spend the fortune necessary to renovate a building that he does not own, he may be prevented from doing so by lease clauses which prohibit alterations without the landlord's consent. Although under the circumstances previously described, any rational landlord should be glad to consent to a sensible alteration, some landlords aren't sensible, and all landlords are bound by the provisions of their mortgages which may, in turn, prohibit alterations. If the mortgage prohibits alterations while the lease permits them, the landlord could find himself in the foolish position of having to stand by and watch the tenant exercise a right that will result in a default by the landlord under his mortgage.

The problem which complicates every lease negotiation is that while the landlord and the tenant do the negotiating, the mortgagee is the ultimate judge of whether the lease is a satisfactory instrument. Neither landlord nor tenant can be sure of the mortgagee's reaction until months after the lease is executed. Mortgage lenders each have their personal or institutional preferences, and different mortgage lenders are governed by so many different legal requirements that it is difficult to predict their reactions.

Nevertheless, a surprisingly large number of landlords have executed leases which permit tenants to make some alterations without the landlord's approval, despite the fact that the mortgage instrument prohibits alterations without the mortgagee's approval. These landlords are dealing with the problem by ignoring it. That is hardly a professional solution. The professional way to handle the problem is to try to understand what modifications a mortgagee would be willing to make in its mortgage to enable the tenant to have some freedom of action to renovate its store.



### *Mortgage Lenders' Views on Alterations*

Mortgagees like to restrict alterations for many reasons. Here are some of them.

They are afraid that unless alterations to mortgaged premises are controlled by the mortgagee, the alterations may be so foolish that the integrity of the building may be impaired. Another possibility is that a building easy to relet might be altered so that it can be used only for an esoteric purpose.

Mortgagees also feel that they are lending money against the security of improvements which are carefully described. They have caused an appraisal of the building or proposed building to be made and an exact building has been reviewed by their committees. If the improper alteration were to decrease the value of the building, the relationship between the unpaid balance of the loan to the fair

market value of the property might be so changed that the mortgagee might find itself with an illegal loan. Illegal loans are embarrassing and must be disposed of, even at a loss.

Some mortgagees prohibit only "structural alterations." What are structural alterations? From an engineering or architectural point of view, the phrase "structural alteration" is absurd. A structural member of a building is one that plays a part in supporting the roof structure. Structural members include the footings, columns, beams, lintels, and roof deck. At times, a wall is structural. However, as long as the mortgage permits the mortgagor to make "nonstructural" alterations, the landlord can permit a tenant to make "nonstructural" alterations. If there is a dispute as to the definition of structural alterations later on, the landlord usually can avoid the embarrassment of having permitted in the lease what is prohibited in the mortgage, because the court will be faced with the same standard in both the lease and the mortgage.

If both mortgages and leases prohibited alterations that violate legal requirements, render the building unsafe or unfit for occupancy, impair the structural integrity of the building, change the character of the building, or diminish the value of the building, both the mortgagee and landlord would have greater protection.

Another way in which the alterations problem has been handled has been to prohibit alterations which cost more than a stipulated dollar figure. Leases which contain such provisions often do not specify if the dollar figure is cumulative or if it relates to single alterations. Under such leases, tenants leasing as much as a 100,000 square feet of floor space find themselves unable to make alterations which would cost more than \$20,000.

Another way the issue is comprised is by providing that alterations cannot be made unless the landlord consents to them. And the landlord agrees not to withhold his consent unreasonably. Unless the mortgage also contains a provision which requires the mortgagee to be reasonable concerning a request for an alteration, a landlord would be unwise to use this provision. However, the landlord can be protected if the lease provides that the landlord will not be deemed to be unreasonable if he refuses consent to an alteration because the mortgagee refused consent.

A tenant alteration may violate the mortgage even if the mortgage doesn't prohibit alterations because the tenant may find it necessary to remove

parts of the existing building and equipment in the course of renovation. Most institutional mortgages prohibit, either expressly or impliedly, the removal of parts of the building or parts of the equipment used to serve the building.

Under normal circumstances, mortgagees are not likely to mind when old equipment is removed and replaced by modern new equipment. However, they do insist that the lien of the mortgage be extended to include new building equipment. One problem may arise here. If the mortgage lien encumbers the tenant's alterations and the tenant's new equipment, the tenant may find itself in the frustrating position of not being able to remove its own equipment at a later date.

Finally, bear in mind that many lenders holding existing shopping center loans would like to see the loans prepaid. You would, too, if you were making 5.5 percent on your money and might be in a position to reinvest it at 9 percent. Such a mortgagee might refuse to allow any activity whatsoever which violated the terms of the mortgage.

### *Compliance With Legal and Insurance Requirements*

Provisions regarding alterations should take into account the requirements of governmental bodies and insurance companies. If a tenant makes an alteration and fails to comply with applicable legal requirements, the landlord can be penalized. The penalties can be criminal penalties and under bizarre circumstances could even result in jail sentences.

If a tenant performs an alteration which does not comply with the requirements of the companies insuring the premises against damage by fire or other casualty, grievous consequences can arise for both the landlord and the tenant. One obvious consequence is an increase in insurance rates. The failure to comply with an insurance company's requirements can result in a cancellation of the insurance contract. If this happens, the landlord might be forced to carry fire and casualty insurance with a company charging higher premiums. Under extreme circumstances, it is possible that no company will agree to insure the premises.

### *Real Estate Taxes and Insurance Premiums*

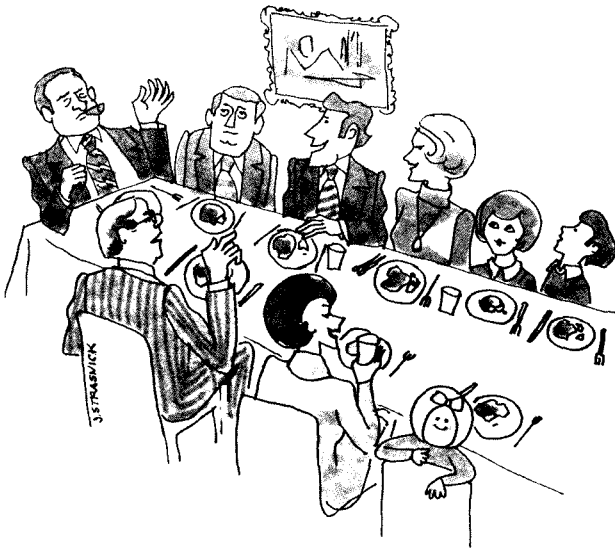
Alterations may cause thorny problems in connection with real estate taxes. If you renovate a building, it is likely that the real estate taxes will rise. If the lease obliges the tenant to pay all real



## People and Property

estate taxes relating to the demised premises, the landlord's agreement to permit alterations won't result in much harm to the landlord. However, most shopping center leases do not contain this type of tax provision. Instead, they provide only that tenants make contributions toward increases in the taxes applicable to the entire shopping center and that they share the increases in some equitable way, often in proportion to the area of their respective premises.

If the taxes on the shopping center are increased as a result of alterations made by one tenant on its own premises, it is unfair to expect that each of the tenants of the shopping center should share the increase. The tenant making the alteration should bear the entire tax increase attributable to the alteration. Similarly, if a landlord makes an alteration to an existing premises in order to induce a second-generation tenancy, the real estate taxes applicable to this shopping center are likely to rise. Again, there is no good reason to expect tenants of premises not affected by the alteration to bear a share of the tax increases.



Another possible increased cost which can arise because of an alteration is an increase in insurance premiums. Fire and other casualty insurance premiums are based upon the replacement value of the premises. If an alteration increases the replacement value of a building, an increase in the cost of insurance premiums may result. A tenant who makes an

alteration should be expected to bear any such increase.

Tenants resist paying increases in taxes and insurance premiums which result from their alterations. They argue that the building belongs to the landlord and that they are doing him a favor by renovating *his* building. If the alteration is substantial enough, such a favor can cost the landlord so much of his cash flow that he might as well abandon *his* building. The fact is, a tenant would not make an alteration to a building unless the remaining term of the lease was sufficient to fully amortize the cost of the alteration. The exotic argument that the alteration is really done for the benefit of the landlord may be considered an exaggeration.

### *Upward Expansion of a Shopping Center Building*

Most shopping center buildings are one-story structures. A minority have basements. Here and there, you will find a two- or three-, and perhaps even a four-level shopping center, but multistory centers are unusual. Most of them are part of large regional complexes.

It sometimes occurs to the landlord or to the tenant that one can sell a lot more merchandise from twice the space, and one can get close to twice the space from a one-story structure by building a second floor. Actually, building a second story above an existing one-story building can be prohibitively expensive unless the original building was designed for subsequent upward expansion and the structural elements are sturdy enough to support the weight of a second story.

Some landlords like to reserve the right to build additional stories over their shopping center building. Such a prospect dismays tenants. Tenants fear principally that the shopping center parking lot will be unable to accommodate additional traffic that will be attracted by the upper-floor tenant.

A tenant who permits his landlord to construct additional space above his premises invites trouble. The noise, dust, and dirt that are inevitable by-products of any construction job are destructive to the operation of a retail business. Machines used by construction contractors may block the entrance or hide the storefront of the existing tenant. The alert retailer will avoid allowing his lease to permit a subsequent upward expansion of the building in which his premises are located.

When it is the tenant who wants to build another floor above the existing building, it may, at first

blush, look as if the tenant is proposing a windfall for the landlord. But the landlord will probably find that many of his other tenants would complain bitterly. Those with carefully drawn leases would litigate. The landlord's taxes and insurance premiums would rise substantially, and the landlord may find himself in default under his existing mortgage.

### *Construction of a Mezzanine*

If the ceiling of a store premises is unusually high, a tenant may decide that he could materially increase his use of the space by building a mezzanine floor. Mezzanines are sometimes used effectively for selling merchandise. Or a mezzanine can be used to increase the storage capacity of a store, thus freeing a part of the ground floor for the sale of merchandise.

The construction of a mezzanine may well be prohibited under the alterations clause of a shopping center lease. A tenant who contemplates the possibility of the construction of a mezzanine should be careful to bargain in the lease for the right to do so. Many of the problems that are applicable to making an alteration also apply to the construction of a mezzanine. These include the questions of violation of the landlord's mortgage, increase in real estate taxes, increase in fire insurance premiums, and problems relating to the maintenance of a sensible ratio between the floor area of the buildings and the shopping center parking facilities.

### *Outward Expansion*

Some tenants anticipate that one day they will want to have a larger store. Supermarket chains are particularly conscious of this need because the size of these types of stores has increased over the years. Most of the supermarkets built before 1950 were around 15,000 square feet in area. By the early 1970s, most supermarket chains considered any space smaller than 30,000 feet too small. Many supermarket chains now insist upon stores which exceed 40,000 square feet.

The tenant concerned with expansion can insist upon one of several provisions in the shopping center lease.

It can require that the landlord build an extension to the building when requested to do so by the tenant. When confronted with such a request, the landlord is, of course, concerned with the ex-

pansion cost and the amount of additional rent the tenant will pay for the additional space.

One national department store chain, now bankrupt, insisted that its landlords bear all the costs of building the additional space. When the expansion was completed, the tenant would pay minimum rent for the new space computed at the same rate as the minimum rent for the original space. Although many landlords accepted this arrangement, it must have occurred to them that agreement to build an extension to a building at any time during a twenty-year period can be risky business. Construction costs have been rising steadily for quite a few years. Since the original annual rate of minimum rent was based upon the cost of constructing the original building, a landlord would expect to lose a substantial amount of money if the tenant exercised its option after construction costs had risen substantially.

Of course, there are much fairer ways to make arrangements to build an extension to demised premises. One way is to increase the rent that will be allocable to the new space in proportion to increases in construction costs. A second way is simply a clause that permits the tenant to build such an addition. If the tenant undertakes construction, it is not likely that minimum rent would be increased in any way. However, when the tenant is given the right to construct an addition to its building, the landlord must worry about noise and dust of construction and the possibility that the businesses being operated by other tenants might encounter difficulties as a result. The lease can contain provisions to protect the landlord against these problems.

In order to increase the size of the premises, the tenant needs the right to tear down the wall adjacent to the addition. The tenant should agree to make all repairs required as a result of the extension it builds. The tenant should expect to carry fire insurance on, and pay real estate taxes for, the new addition. On the other hand, the tenant may seek to offset the cost of building the additional space against increases in percentage rent which may occur as a result of the addition. The recoupment can be measured by comparing gross sales after the completion of the addition to the gross sales made during years just prior to the construction of the addition.

Although the construction of an addition may be legal at the time the lease is signed, it is possible that the zoning laws will change between the



## People and Property

signing and the commencement of the addition. The landlord should condition his obligation so that he will be excused in case the zoning laws are changed. Similarly, permission to construct an addition should be conditioned so that the tenant will not be able to construct an illegal building in the shopping center.

The lease should indicate the exact location of the land on which the addition may be built and provide that the addition will be designed so as to blend with the existing building.

### CONCLUDING THE MEMO

I was determined to finish the project that night. The children fell asleep a little after their normal bedtime. I felt lonely without them, but I kept

pushing, and I finished dictating at about 3 A.M.

The following morning was Sunday. That's a good day to sleep late, and I did. After an 11 A.M. breakfast, I walked over to my desk and was horrified to see the children sitting there and dictating into my tape recorder. Had they erased the material I struggled so hard to create the night before?

I played back the whole tape and was relieved to discover that they had not disturbed my precious dictation. What they *did* do was to add some advice of their own to Harry about the condition of vacant supermarket buildings. I shall pass it on to you.

Eve: When the roof of a supermarket leaks, put a garbage can under it!

Dan: Remember that a supermarket chain—is attached to the checkout counter.



### FOREIGN-OWNED ACREAGE IN THE UNITED STATES

A Commerce Department survey published in 1976 indicated that foreign-controlled businesses owned 4.9 million acres of United States land at the end of 1974. This total was broken down as follows: slightly over 1 million acres was in agricultural land; 1.3 million, connected with manufacturing enterprises; 900,000, directly in the real estate industry; 500,000, owned by foreign-owned petroleum firms; and 1.2 million acres, all other categories including hotels, resorts, golf courses, timber and mining.