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The Real Estate Institute of New York University

Exploring the infinite variety of problems encountered in assembling a parcel, and developing a shopping center in stages.

Giant Jigsaw: Putting Together A Shopping Center Site

Emanuel B. Halper

Multiple ownership of shopping center parcels is a perplexing but profoundly important phenomenon.

Were God to have created the world in neatly arranged, rectangular, flat, twenty-acre parcels, all lying at intersections of bustling highways, the community shopping center developer and discount store operator would find the earth a harmonious paradise. If the rectangles were somewhat rearranged and combined, the regional shopping center operator of today would be ecstatic.

Reality confronts us with the most confounding combinations of sizes, shapes and locations. It is the job of the developer and his lawyer to rearrange, combine, and subdivide, to enable the shopping center plant to exist. As if coping with farmers and land speculators when buying or leasing the land is not enough, we must satisfy the tenant who insists upon owning his own land, the tenant who insists upon leasing his own land, the tenant who wants a building built for him, and the tenant who is interested but wants to wait. Add the following to the confusion: spiraling building costs, unbelievably high interest rates, state laws restricting institutional investments in leaseholds, usury laws, a complicated income tax statute, and an inflation psychosis.

To unscramble this web requires patience.

Mr. Halper is a partner of the New York City law firm, Zissu, Halper & Martin. He is Assistant Treasurer and Assistant Secretary of Vornado, Inc. Mr. Halper is a lecturer at New York University's Real Estate Institute and a member of the Law Committee of the International Council of Shopping Centers. This article is based upon a speech given before the International Council of Shopping Centers, at Safety Harbor, Florida, in October 1970.

The conditions I've listed result in three principal problems, which we will discuss in some detail below:

▲ *Assembling.* We find a fabulous location, but it is divided into eight different tracts.

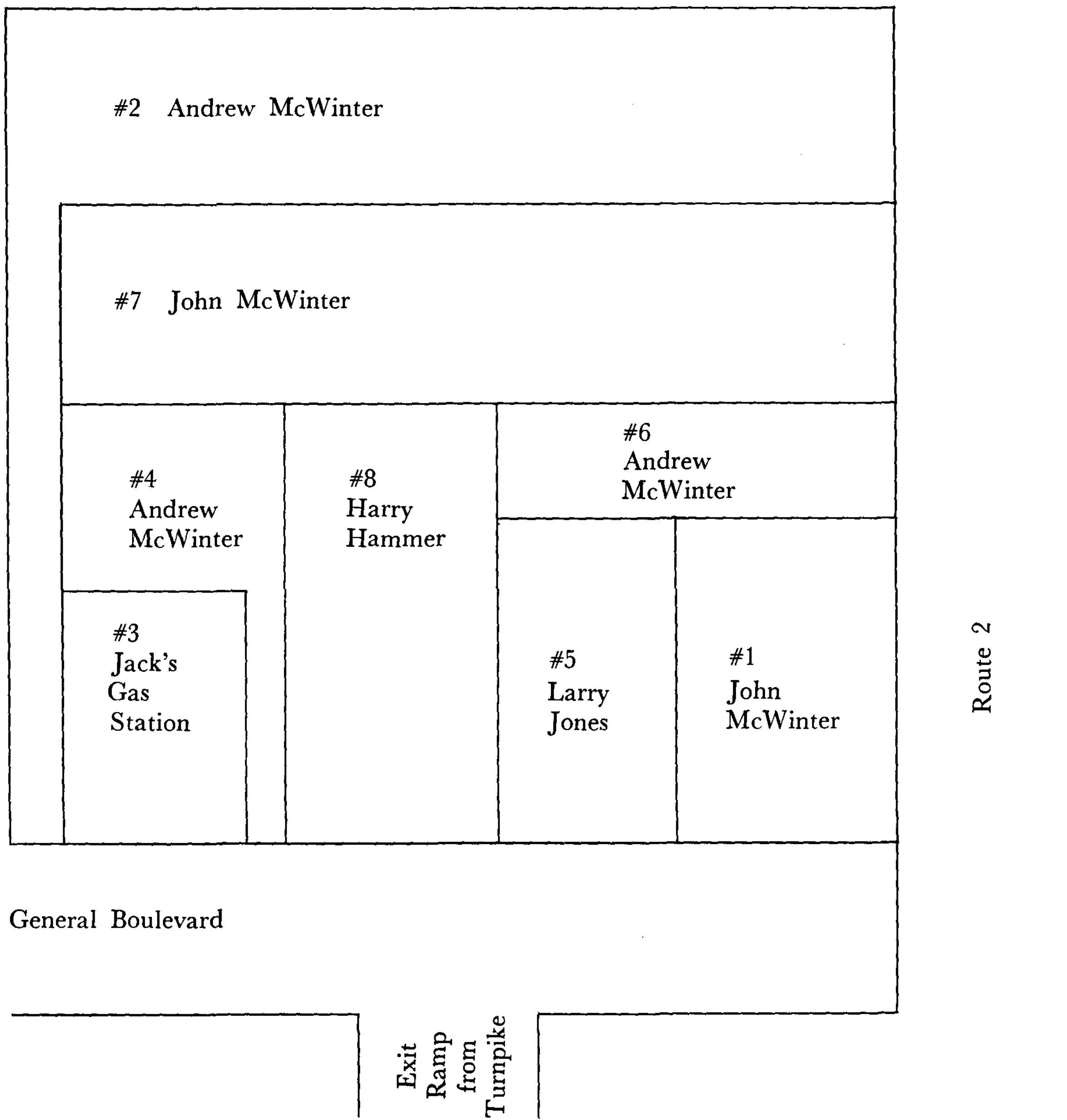
▲ *Staging.* We would like to build a twenty-acre center today, and expand it to thirty-five acres in five years; but this property and fifty acres more is owned by one person who will sell none of it, but will lease all of it—*only* all of it.

▲ *Inducing a Tenant.* We've got the right sized parcel and the owner will play ball. However, the department store tenants will allow the developer to build their buildings only if the floors are flown in from Italy and rare Aztec relics are hung every five feet at the developer's expense. And all this for a rent of $1.28 gross. Then the developer asks the department stores, "Would you consider leasing your own land and building your own building?"

ASSEMBLING

The picture of the assembled jigsaw puzzle stares at us in the shape of a skillfully drawn plot plan. What beautiful stores! What great cash flow!

Unfortunately, the fifty acres we want are divided into eight tracts. See a simplified diagram of the premises below:



How many times have we seen this? Our land (ours still only in fantasy) was purchased in foreclosure sales from farmers and assembled in 1898 by Job McWinter, a teacher who emigrated to our town from England. He died in 1920. His executor conveyed three parcels (#3, 5 and 8) to businessmen and the other five (#1, 2, 4, 6 and 7) to his two sons, John and Andrew. John and Andrew hate each other, of course. Somehow it must have been an infernal plan. We can't put together anything unless *both* John and Andrew will cooperate. Andrew won't sell but he'll lease. He told us that he'll never subordinate. John will subordinate, unless you tell Andrew, and embarrass him. Jack's Gas Station won't move but might consider it if you build a new gas station at the corner of Route 2 and General Boulevard.

To tie the package of our problem site together, we will need the patience to get at least five leases or deeds executed. Because of the layout, it is really essential to deal with each of the owners of the parcels and their eccentricities. John and Andrew are most important, of course, and their refusal to cooperate can prevent any development from taking place. We must use the utmost patience and tact in dealing with them. However, we must negotiate simultaneously with Hammer, Jones and Jack's Gas Station, who have different desires. As we conduct our negotiations, we must keep the following problems in mind as well as those outlined further down below:

☐ The parcels must be contiguous to each other.

☐ All must be properly zoned.

☐ Our estate in each parcel must be a legal investment and an interesting investment to a lender.

☐ Our leases and deeds may not restrict our use to any great degree.

☐ All must be joined together by an agreement or declaration providing for the operation of a unified shopping center, including the unimpeded flow of vehicular and pedestrian traffic.

Questions of assuring contiguity and zoning are not peculiar to land leases and we need not explore them thoroughly here.

Can we combine "unsubordinated" leasehold estates in tracts #2, 3 and 6 with subordinated leasehold estate in tracts #1, 7 and 8, and a fee estate in tracts #4 and 5 as security for one loan? Of course we can. Since the owners of five parcels and the owners of six leaseholds will execute the mortgage, we have a combined leasehold and fee mortgage. Possible? Yes. Desirable? Well, that depends on the developer and his lawyer. We must, however, overcome the hurdle of convincing the lender and its attorneys that its security is safe.

Certainly it is desirable to try to keep the provisions of the leases as uniform as possible, if for no other reason than to keep the mortgagee's attorney happy. Each "unsubordinated" lease must separately meet the tests required by the lenders and their attorneys.

The pieces must tie together neatly so that the result is a functioning, integrated shopping center capable of being financed.

In an assemblage, from time to time, it will be necessary for the developer to be satisfied with diverse estates. Sometimes he will be able to purchase (and this may be his only option even if he prefers to go the leasehold route). Some owners will refuse to sell, but will lease, and some of those who will lease will also agree to execute fee mortgages (i.e., "subordinate"). There is no impediment to a loan which is secured partially by a leasehold and partially by a fee mortgage as long as statutory requirements are met for each type of security. In fact a portion of the security might well be a mortgage of an easement. Of course some lenders may balk because of the complexity of the transaction.

Tying the diverse pieces together by a clear and comprehensive easement declaration goes a long way toward creating order out of chaos and allaying the lender's fears of complexity. The declaration should not fail to include the following material:

☐ All parcels must be operated as a unified shopping center.

☐ The owners and lessees of each parcel must have the right to use parking, mall and other facilities in common. The lenders must be in a position to prevent common facility rights from being extinguished by the defeasance of a leasehold estate.

☐ No fences separating parcels may be permitted.

☐ The uninterrupted flow of traffic by foot and vehicle among the parcels and the abutting highways must be assured.

☐ The parking areas and accessways must be constructed and maintained. Of course, provisions should be made for lighting, striping, drainage, cleaning, repairs, insurance and snow removal.

☐ The mall must be constructed and maintained. Provisions must be included for heating, air-conditioning, cleaning, lighting and repairing.

☐ The covenants should run with the land in cases where the developer acquires the fee. If the developer has acquired a leasehold interest and the landlord will not burden his fee with the easement

declaration, the covenants must be binding on each successor owner of the leasehold.

☐ Arrangements should be made for easements of support in case it is necessary for a part of a building to rest on the footing or foundation of another parcel.

☐ A party wall agreement may be necessary.

☐ Provision should be made for easements to utility companies and municipalities in connection with bringing water, electricity, gas, telephone and other services to various parts of the premises and the discharge of sewage and drainage therefrom.

Further complications may arise with local zoning authorities where there are side-yard requirements for each parcel. The easement agreement will usually solve the problem. Where some of the parcels are not owned but leased by the developer, the zoning authorities may have their own requirements as to the length of the leases. Similar problems can come from fire codes which may, on their face, appear to make construction more expensive by insisting that fire rated walls separate different lots.

The great care necessary when integrating the parcels of an assemblage is even more apparent where the individual parcels or leaseholds thereon are mortgaged separately as security for different loans. Of course, what may occur is that provisions which will satisfy one lender may not satisfy another. The lenders themselves may argue over the appropriateness of one clause or another in the easement agreement.

If you have purchased seven parcels and are able to lease (but not purchase) an essential eighth parcel, it is not too good an idea to rely on the so-called "subordination" clauses in the lease. (If, indeed, there is one.) When you put the mortgage in front of him the landlord might not execute it. That might create quite a mess and you might be on your way to insolvency. "Subordination" is not always enforceable. Litigation in Hawaii and California indicates that the courts of these states won't enforce such a covenant unless many aspects of the loan to be secured by the fee mortgage are carefully delineated. Even if the courts in your state do enforce your particular "subordination" clause, they aren't likely to do so in the brief period between mortgage commitment and closing. So be sure that the leasehold itself is "mortgageable."

Similar problems come about in urban assemblages. In such an assemblage the developer may acquire a leasehold interest over air rights. Sometimes these leases are executed to comply with bulk requirements of zoning ordinances. In other situations the developer will construct a building on the premises demised by the lease of air rights. Additional problems to be met are in describing the demised premises as an air mass over a particular land mass, the location of easements for support of columns, and the location of an easement for staircases, pipes, wires and elevators.

STAGING

When the developer enters into a lease with an owner for a parcel larger than the developer can use all at once, he is confronted with dividing it into economically useful segments. Even where only a small parcel is leased and improved, a developer may find at a later date that an unneeded part of the parking area might be severed from the shopping center and be used for a gas station or fast food operations.

Mortgaging a leasehold is different from mortgaging real estate. If you own the fee, you can always divide it (assuming that any applicable subdivision and lot splitting ordinances are complied with). However, you can't mortgage a part of a leasehold.

What do you do? The ground lease must provide that the tenant has the option to require the landlord simultaneously to (i) cancel the lease, and (ii) execute two or more additional leases. By the new leases the demised premises are divided into as many parcels as desired and there is a separate lease for each parcel. Of course, the aggregate of all the separate parcels should equal the area of the demised premises, and all the parcels must be tied together with an easement agreement. It sounds simple, but it might not be.

What about the rent? If landlord will buy it, each of the separate leases will provide for a rent which bears the same proportion to the rent under the original lease as the area of the parcel demised by the new lease bears to the original demised premises. It is simple but the landlord will fight you like a tiger. This is a problem very similar to the familiar problem of releases from a purchase money mortgage. If the landlord permits tenant to allocate rent in proportion to area, the most valuable parts of the original demised premises may be governed by a lease with an unrealistically low and unfair rent. Since the tenant-developer cannot consent to a provision that a default under one lease constitutes a default under the others, the landlord someday might find tenant abandoning less desirable parts of the demised premises while keeping the rest.

Some problems that are common to assemblage situations and staging situations are: bringing utility services to the site; discharging sewage therefrom; and effective design of traffic patterns. Every attempt should be made to provide in the lease that landlord will subject his fee interest in the demised premises

to suitable easements for the necessary lines. Frequently a municipality or other governmental authority will request that a portion of the premises be dedicated for public use as a *quid pro quo* for the issuance of a building permit. A governmental authority is not easily satisfied with a leasehold interest. They want to own the property. Therefore, the lease should require landlord to convey it to the public authority free of the lien of the lease. Under these circumstances, rent would not be reduced and landlord should receive no compensation for the conveyance.

For example, the State of New Jersey has a requirement that the state highway department demand a conveyance to it of property suitable for acceleration and deceleration lanes. This demand arises as part of the State's highway safety program. Under the highway safety program, median traffic dividers are being constructed. Of course, a median divider will prevent a left turn into the shopping center, depriving access to it by fifty percent of the available traffic. The conveyance of the acceleration and deceleration lanes is requested as consideration for the State's construction of a jughandle on the opposite side of the road, a traffic light, and a median divider. (These facilities permit a smooth left turn directly into the shopping center.) Therefore, in New Jersey and states with similar requirements, the developer must use every effort to induce the landlord to agree to dedicate a portion of his property for public facilities.

INDUCING THE TENANT

Another way diverse ownership may arise is if the developer gives or leases land to a department store. The obvious consideration for a gift of land, or cheap rent, is the department store's covenant to operate. This relationship requires adding to the easement agreement, or declaration, such provisions dealing with:

- Control over signs;
- Contributions to the merchant's association;
- Contributions to common area and mall maintenance;
- Restrictions against competition, or undesirable uses;
- Hours of operation; and
- Construction of the department store.

CONCLUSION

In a changing America, the shopping center is destined to play a role as the hub of a shopping-residential, industrial-recreational center. The simple pattern of buying property, and mortgaging it to one lender, or leasing from one person, frequently yields to some of the arrangements described above. Developments involving hundreds and perhaps thousands of acres, with different but compatible uses, are in existence already. Many more surely will follow. And with such projects we will be sure to find diverse land ownerships, a need for staged development, a need for many lenders, and all of the complications that these situations bring.

Commenting on the President's proposal [for a simplified revenue sharing plan], HUD Secretary Romney said that the present complex categorical grant system reminded him of "a 20-mule team harnessed in the dark by a blind one-armed idiot."

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