

Retail Commercial Real Estate Is Evolving, Not Dying

By **Jared Oakes and Barry Guttman** (August 1, 2018, 1:48 PM EDT)

Don't believe everything you read about retail commercial real estate. If you just looked at the headlines, then you would see that, since reaching a peak of 146.51 on July 25, 2016, the Dow Jones U.S. Retail REIT Index has fallen to 106.15 as of July 25, 2018.[1] You would see that there's been increased talk of consolidation and elevated M&A activity in the retail real estate investment trust world[2] and, as indicated by Brookfield Property Partners LP's agreement to purchase GGP Inc.,[3] REITs are being taken private. You would see articles about dozens of retailers declaring or about to declare bankruptcy[4] and predictions that retail CRE is dead or dying.[5]



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But is that actually an accurate picture of the retail CRE world in 2018, or is the headline risk overblown? In Q1 2018, according to data from the U.S. Department of Commerce, approximately 9.5 percent of the \$1.307 trillion in retail sales during the same period occurred online.[6] While this represents a 16.4 percent increase in the amount of online sales as compared with Q1 2017, it also means that over 90 percent of retail sales are still occurring in brick and mortar stores. And there are still retailers opening up stores across the country.[7]



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Instead, a more accurate description would be that retail CRE is rapidly evolving,[8] perhaps in its most volatile period of change ever. Fierce competition from Amazon and other online retailers is causing traditional retailers to look more toward omni-channel sales.[9] Nordstrom recently announced a radically different store concept that's been described as "like shopping online – only in real life." [10] Once exclusively online retailers like Warby Parker and Bonobos are themselves pursuing brick and mortar stores to grow and meet consumer demands for a physical shopping experience.[11] Private equity is simultaneously driving the profitability of some retailers by effecting operational improvements, while distressing others under the burden of unsustainable debts.[12] The United States Supreme Court recently decided *South Dakota v. Wayfair*, opening the door for states to levy sales taxes against online retailers in ways that were previously impossible.[13] Depending on how states react to the Supreme Court's decision, the playing field between brick and mortar retailers and their online competitors may become more level than it ever has been with respect to sales tax.

In such a rapidly shifting landscape, developers and landlords are searching for ways to reinvigorate and add value to existing centers, while also working to stay relevant to modern consumers. Real opportunity exists for developers who are willing to put in the effort to find the right strategy to redevelop underperforming assets. For many, the holy grail is experiential retail — personalized, engaging activities for visitors. However, in order to pursue these redevelopment strategies to add experiential retail, developers need flexibility. Whether and to what extent developers have this flexibility can make or break a shopping center's financial profitability.

When looking to redevelop a shopping center asset, developers are often faced with a litany of issues stemming from the sometimes-competing interests of various third parties who may have an interest in the shopping center, including (i) tenants, (ii) shadow anchors and REA parties, (iii) lenders and investors and (iv) governmental authorities. A sampling of some considerations arising out of redevelopments is addressed below. For purposes of this article, the items below address a scenario

in which a developer is looking to redevelop space that has been vacated by a major anchor tenant. While there are certainly other considerations to be evaluating in the context of any redevelopment, the issues below are those often raised in the specific context of experiential retail redevelopment.

Tenant Issues

- *Consent Rights Over REA Changes.* Many larger tenants' leases give those tenants consent rights over any changes to the underlying structural documents, such as REAs, that created and require keeping in place an existing shopping center or enclosed mall. Sometimes that consent can be withheld in the tenant's sole discretion, which means tenants can hold developers hostage, even if the tenants themselves might actually support the redevelopment. As a result, carefully reviewing the leases to determine any such consent rights is critical — or else developers risk being sued by tenants and potentially suffering millions of dollars of damages, similar to what occurred in the well-known case *Lord & Taylor LLC v. White Flint LP*, 849 F. 3d 567 (4th Cir. 2017) (the White Flint case).[14]
- *Use Restrictions.* Particularly with older leases, many of the uses most central to successful experiential retail — such as restaurants, entertainment venues, gyms and the like — are prohibited or significantly restricted under tenants' leases. While the industry has recognized that the lists of prohibited uses that once made sense need to be modernized, very little actual progress has been made because tenants have been able to successfully leverage their consent rights. Accordingly, a thorough review of tenants' leases is necessary to determine any use or other restrictions that might apply to the proposed redevelopment.
- *Co-Tenancy.* Another reason to review tenants' leases is because many leases, especially those with larger or more sophisticated tenants, contain co-tenancy clauses requiring specific named anchor tenants and/or a percentage of the gross leasable area, or GLA, of the shopping center to remain open and occupied. With respect to the named anchor tenants, many leases will also provide certain replacement tenants that can suffice to satisfy the co-tenancy requirement. While adding an experiential retailer would certainly help satisfy percentage GLA co-tenancies (and may be more beneficial to the shopping center's health), when considering potential experiential retailers to backfill a named anchor co-tenant's space, developers should consider whether the experiential retailers qualify as replacement tenants for purposes of satisfying existing tenants' co-tenancy requirements.
- *Site Plan Controls; Physical Restrictions.* Leases will also frequently contain restrictions against modifying the common areas, protected areas or even building outside certain prescribed "permitted building" areas. Sometimes these will be a blanket prohibition against common area modifications or modifications to the site plan, while other times the lease will only restrict landlords from modifying the common areas in such a manner as to materially adversely affect a tenant's access or visibility. Material redevelopment plans often change the site plan and common areas in ways that may not be contemplated in leases that contain site plan controls. Accordingly, common area and site control provisions that may otherwise seem boilerplate should be carefully reviewed as part of the redevelopment analysis. On a going forward basis, landlords should pause before granting these types of site plan controls to tenants or carefully limit the scope of these controls.

Shadow Anchor or REA Party Issues

- *Antiquated Language.* Many REAs, declarations and similar title documents will also contain restrictions on concentrations of uses (e.g., restaurants and entertainment uses), prohibitions against demalling, limitations on developers' ability to change the interior of the mall or demolish existing stores, as well as use restrictions and common area restrictions similar to

those described above. However, because these types of title documents often tend to survive far beyond the original parties who entered into them, the documents may use terms that seem innocuous today but meant something different at the time they were executed, which may give current REA parties grounds to contest the redevelopment. For example, older REAs restricting against “health clubs” were arguably intended to prohibit what we would now call a gym or fitness user, even though today there may be a difference between health clubs and gyms. As a result, thorough review of those title documents for these kinds of restrictions is crucial.

- *Parking Requirements.* Like leases, title documents will often contain provisions specifying certain parking requirements. These can include required minimum parking ratios for the shopping center (or parts of the shopping center) that may be based on certain uses, tenants or occupants that may exist within the shopping center; critical parking areas that must be maintained as parking; and critical access points to the parking areas that cannot be changed. In some instances, parking requirements that were established decades ago are more restrictive than necessary to accommodate a modern shopping center’s parking needs. Here too, determining whether a redevelopment would trigger a violation of these parking requirements is critical.
- *Identifying Consent Parties and Obtaining Consents.* Once it has been determined that a title document contains restrictions from which the developer needs relief, which is more likely in the context of experiential retail redevelopment than other redevelopment projects, another issue presents itself: who are the current parties-in-interest with consent rights under the title documents? Particularly at older properties with several outparcels or ground leases, identifying these parties may not be as simple as obtaining title work for all the parcels affected by the applicable document, as consent rights may not always run with the land. Moreover, even after the appropriate consent parties have been identified, their consent must be obtained — which often comes at a cost to the developer and the redevelopment.
- *Ask for Permission or Beg for Forgiveness?* Historically, in the retail CRE industry it was not uncommon to hear the mantra, “I’d rather beg for forgiveness than ask for permission.” While there are likely many cases demonstrating the risks of that approach, none does so more vividly than the White Flint case. White Flint involved a developer who wanted to redevelop a failing mall in order to return it to profitability, but Lord & Taylor had consent rights and refused to grant such consent. The developer proceeded with the redevelopment anyway, and ultimately the developer was ordered to pay Lord & Taylor \$31 million in damages, including potential lost profits.[15] The dangers of cases like White Flint speak to how careful developers should be when granting consent rights to third parties that may come to have competing interests with the developer.

Lender or Investor Issues

- Even before a redevelopment scenario arises, it is critical to structure the debt and equity for a project in a manner that not only gives developers flexibility to use their expertise in redeveloping an otherwise-struggling shopping center, but also provides lenders and investors sufficient comfort that their capital is being deployed in an acceptable manner relative to their respective risk tolerances. In that vein, discussions between developers and their capital providers may center on particular risk profile of the experiential use(s) involved with the redevelopment, which would not be the case if a developer sought to backfill an anchor tenant’s space with another traditional anchor retailer.
- Depending on how a particular project was originally financed, loan agreements, joint venture agreements or other financing documents may have given (and often give) these third parties

approval rights over any redevelopment of a shopping center. In particular, existing lenders' consent will almost always need to be obtained in order to get new financing for the redevelopment, and equity investors' consent may also be needed or they may be asked to make an additional capital raise. Once a developer is considering redevelopment, the debt and equity documents should be carefully reviewed to ensure that all necessary consents are obtained.

Governmental Issues

- Restrictions in applicable zoning codes might be implicated by the proposed redevelopment of a shopping center. In particular, the permitted uses, parking ratios and setback requirements specified in zoning codes may require getting a variance or conditional use permit in order to allow an experiential retailer to operate.
- If the developer intends to finance the redevelopment with TIF or other public financing, then developers should carefully consult with counsel to determine whether and to what extent an experiential retailer's use and any modifications to the shopping center necessitated by the redevelopment qualify for such financing under applicable laws.

Given the complexity of these issues and their interplay, it is critical to have creative and thoughtful legal, financial and tax advice, as well as a deep network of contacts who can help navigate these issues with the appropriate parties.

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[1] <https://www.marketwatch.com/investing/index/djusrl?countrycode=xx>

[2] <https://www.reit.com/news/reit-magazine/march-april-2018/are-malls-ready-deal>

[3] <https://bpy.brookfield.com/en/press-releases/2018/03-26-2018-230530913>

[4] <http://www.businessinsider.com/retail-bankruptcies-expected-this-year-2018-3>

[5] <https://www.zerohedge.com/news/2018-04-17/death-retail-real-estate-continues-77mm-sqft-shopping-space-closed-2018-already>

[6] https://www.census.gov/retail/mrts/www/data/pdf/ec_current.pdf

[7] <https://www.fool.com/slideshow/these-9-retailers-are-actually-opening-stores/>

[8] <https://www.bloomberg.com/news/articles/2018-04-17/as-toys-r-us-fails-the-retail-real-estate-glut-is-getting-worse>

[9] E.g., <https://www.prnewswire.com/news-releases/tailored-brands-innovates-with-new-omnichannel-customer-experience-300631622.html>

[10] <https://www.gq.com/story/nordstrom-new-york-mens-store>

[11] <http://www.adweek.com/digital/why-these-2-niche-ecommerce-brands-are-opening-up-more-brick-and-mortar-stores/>

[12] <http://fortune.com/2018/04/24/retail-private-equity-investors-mall-shopping/>

[13] https://www.supremecourt.gov/opinions/17pdf/17-494_j4el.pdf

[14] https://scholar.google.com/scholar_case?case=14553354789334547918;
<http://www.bethesdamagazine.com/Bethesda-Beat/2017/White-Flint-Mall-Property-Owners-To-Pay-Lord-Taylor-after-Lengthy-Legal-Battle/>

[15] <http://www.bethesdamagazine.com/Bethesda-Beat/2017/White-Flint-Mall-Property-Owners-To-Pay-Lord-Taylor-after-Lengthy-Legal-Battle/>