

# Top 10 Issues To Consider When Selling A Pad In An Operating Shopping Center

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During the recession of the last few years, many developers elected to sell pads in operating shopping centers as a way of raising capital. In most of these situations, the pad is being utilized by a single tenant. If the tenant is creditworthy (e.g., McDonald's or Walgreens), there is no shortage of buyers. With bond and CD yields at historic lows, and with a stock market that has fluctuated wildly in the last ten years, investors find these pad sales very attractive for their returns and are willing, in many cases, to purchase these pad parcels for cap rates in the 5.75% to 6.50% range.

While it might appear that such a sale would be quite simple, this is definitely not the case. Although the actual purchase agreement is usually reasonably simple and can be consummated rather quickly, the hard part is properly documenting the relationship between the pad parcel owner (the "Pad Owner") and the shopping center developer - the owner of the remainder of the operating shopping center after the sale (the "Shopping Center Owner").

To document the relationship between the Shopping Center Owner and the Pad Owner after the sale of the pad (the "Pad Property"), the parties must enter into some form of recorded document in the nature of a reciprocal easement agreement with covenants and restrictions. The lone exception would be when such a document already exists at the shopping center. However, if such a document does exist, it probably still does not alleviate the need for the parties to enter into an additional recorded agreement, since it is hard to imagine that the existing recorded agreement covers all of the items that will need to be addressed in connection with the relationship between the Shopping Center Owner and the Pad Owner. For purposes of this article, it is assumed that no such recorded document exists. The new document that needs to be recorded can be referred to as an "Agreement of Covenants, Restrictions and Easements Relating to Parcel Sale" (the "Pad Sale REA").

The Pad Sale REA needs to be carefully drafted and considered based upon the composition of the shopping center and the business terms between the Shopping Center Owner and the Pad Owner. However, the most important items that should be considered when drafting the Pad Sale REA are as follows.

1. Easements for Parking, Access, Signage and Utilities. The Pad Sale REA should provide the Shopping Center Owner and the Pad Owner with at least the most basic rights for their respective properties, so that they may be operated in harmony with one another. The Shopping Center Owner and the Pad Owner and their respective agents, contractors, employees and invitees should each have the non-exclusive right to access the other party's property for vehicular parking and access and for pedestrian access. For instance, the customers and employees of the tenant located on the Pad Property (the "Pad Tenant") and the customers and tenants of the property retained by the Shopping Center Owner (the "Shopping Center Owner's Property") will each need the right to park and walk anywhere they desire within the shopping center (subject to an agreement by the parties to provide special areas for employee parking). To customers of the occupants of the shopping center, the property will appear to be owned by one party and

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operated as a fully integrated project (even though the shopping center is owned by two or more different parties). Each party may also need to “tie into” the other parties’ utility systems; which would more likely be the Pad Tenant “tying into” the Shopping Center Owner’s utility systems for the shopping center. In addition, if the Pad Tenant has panels located on a monument or pylon sign on the Shopping Center Owner’s Property, the Pad Owner will require easement rights to access such sign so that the Pad Tenant can alter, maintain, repair and replace its panels on such sign(s). The same would be true for the Shopping Center Owner if it has a monument or pylon sign located on the Pad Property that contains panels used by the tenants of the Shopping Center Owner. In this latter case, the Shopping Center Owner would require the right to access and maintain the entire sign structure, as well as the panels of the tenants located on the Shopping Center Owner’s Property. All of the foregoing rights commonly take the form of “easements” and should be set forth in detail in the Pad Sale REA. These “easements” would effectively allow one party to use (on a non-exclusive basis) the property of the other party.

### 2. Construction and Alterations.

The Shopping Center Owner will want to control the exterior appearance of the building on the Pad Property (the “Building”) so that it can maintain a uniformity in the architectural appearance of all of the buildings in the shopping center. Therefore, it is extremely important that the Pad Sale REA require that alterations to the exterior of the Building be subject to the reasonable approval of the Shopping Center Owner or to the design criteria for the shopping center, which can be an exhibit to the Pad Sale REA. In addition, the size and footprint of the Building will be of great concern to the Shopping Center Owner. The Shopping Center Owner will typically have land use approval rights to construct or operate a certain square footage of building areas within the shopping center. If the Pad Owner expands the size of the Building, this could reduce the permitted building square footage that the Shopping Center Owner can construct or operate elsewhere in the shopping center. Therefore, an increase in the footprint of the Building on the Pad Property can significantly adversely impact the Shopping Center Owner’s rights, not to mention the parking and vehicular thoroughfares within the shopping center.

### 3. Maintenance of Common Area.

The Shopping Center Owner will want the right to continue to maintain the common area located on the Pad Property and bill the Pad Owner for the costs thereof. However, the Pad Owner will already have certain obligations to the Pad Tenant with respect to common area maintenance, as well as the requirement to bill the Pad Tenant for such common area maintenance costs. It is important for the Pad Owner not to agree to pay common area maintenance costs to the Shopping Center Owner beyond those that the Pad Tenant has agreed to pay under its lease. To do so, would seriously erode the yield that the Pad Owner believes it is receiving in connection with its purchase of the Pad Property. The Pad Owner is also vulnerable in the event the Shopping Center Owner does not maintain the common area in the condition required by the Pad Tenant’s lease. If the Shopping Center Owner fails to so maintain the common area, the Pad Owner could be in default under the Pad Tenant lease without any effective remedies. Therefore, the Pad Sale REA should allow the Pad Owner the right to cure such default and seek payment for its costs from the Shopping Center Owner.

If the Pad Sale REA does not require the payment of common area maintenance expenses beyond those required of the Pad Tenant, the Pad Owner may want to negotiate a provision in the Pad Sale REA whereby the Shopping Center Owner will continue to bill the Pad Tenant directly for its share of common area maintenance expenses. This significantly reduces the administration costs that would be required of the Pad Owner if it was

required to collect these costs directly from the Pad Tenant and then pass them along to the Shopping Center Owner.

The Pad Owner might also negotiate in the Pad Sale REA the right to self maintain the common area located on the Pad Property. The Shopping Center Owner might be willing to provide the Pad Owner with this right, subject to the right of the Shopping Center Owner to “takeover” this maintenance if the Pad Owner does not perform such maintenance in accordance with the standards set forth in the Pad Sale REA. However, the Pad Owner usually does not want this responsibility since it is usually a passive investor looking to “clip coupons” and not have any other major responsibilities with respect to the Pad Property.

In some cases, the Pad Tenant is already maintaining the common area on the Pad Property. In this event, it would make sense for the Pad Tenant to continue these responsibilities.

#### 4. Maintenance of Building.

The Shopping Center Owner has a vested interest in knowing that all buildings within the shopping center will be maintained in a similar first-class condition. Therefore, it is important that the Pad Sale REA require the Pad Owner to maintain the Building in a first-class condition and appearance consistent with the buildings located on the Shopping Center Owner’s Property.

#### 5. Damage to Building.

In the event of damage to the Building or common area on the Pad Property, the Shopping Center Owner will want the right to require the Pad Owner to rebuild the damaged improvements to substantially their prior condition pursuant to plans and specifications approved by the Shopping Center Owner. However, the Pad Owner is going to resist this obligation if the Pad Tenant does not have this same obligation, or if it is not required of the Pad Owner in the lease with the Pad Tenant. The Pad Owner can agree to rebuild the Building and common area located on the Pad Property if it is required to rebuild these improvements under the lease with the Pad Tenant, or if the Pad Tenant is required to rebuild these improvements pursuant to the terms of its lease. If not, the Pad Owner should attempt to negotiate in the Pad Sale REA the right to raze the Building and rebuild the common area located on the Pad Property.

#### 6. Use of Pad Property.

The Shopping Center Owner will want the right to control changes in the use of the Pad Property so as to protect against duplication of uses at the shopping center and violation of exclusives. However, the Shopping Center Owner should not have the right to control any change of use permitted pursuant to the Pad Tenant lease. If the Pad Tenant has the right to change the use of its premises with the consent of the Pad Owner (and such standard of consent is a “reasonable” or “sole discretion” standard), the Shopping Center Owner might also want the right to consent to any change in use (based upon the same standard for consent set forth in the Pad Tenant’s lease).

In addition, if the Pad Property is not used for any retail or restaurant use for an extended period of time, the Shopping Center Owner will want the right to repurchase the Pad Property so that it can attempt to lease the Building. Almost nothing is less attractive in a shopping center than a “dark” store. If the Pad Owner agrees to a repurchase right, it shall only do so if the Pad Property has not been used for an extended period of time (i.e., six months or more) and is not due to a remodel or force majeure events like casualties. The purchase price for any repurchase is usually the then fair market value of the Pad Property. The parties usually have a limited period of time to agree upon the fair market value of the Pad Property. However, if they are unable to agree upon the fair market value of the Pad Property, an appraisal

mechanism is typically utilized.

7. Right of First Offer or First Refusal.

The Shopping Center Owner will want the Pad Sale REA to contain a "right of first refusal" or "right of first offer" so that it will have the first opportunity or right to purchase the Pad Property in the event the Pad Owner desires to sell the Pad Property to an unaffiliated third party. The "right of first offer" would be at a price provided by the Pad Owner to the Shopping Center Owner. In the event the Shopping Center Owner declines to purchase the Pad Property at this price, the Pad Owner would have the right to sell the Pad Property to the unaffiliated third party. However, the Shopping Center Owner will want the Pad Owner to again offer the Pad Property for sale to it if the Pad Owner is unable to sell the Pad Property within a specified period of time (i.e., twelve months) for a price equal to or greater than ninety-five percent of the purchase price offered by the Pad Owner to the Shopping Center Owner.

A "right of first refusal" would not be as desirable to the Pad Owner since it would require the Pad Owner to first negotiate terms for the purchase of the Pad Property with an unaffiliated third party and then offer the Pad Property to the Shopping Center Owner for purchase. It is argued that a "right of first refusal" has a chilling effect on buyers and brokers because they could spend a significant amount of time negotiating with a buyer for the purchase of the Pad Property only to have the Shopping Center Owner purchase the Pad Property. In this case, the broker would not get paid, the possibility of which deters brokers from spending too much time on the sale of property subject to a "right of first refusal."

8. Existing Exclusives at the Shopping Center Property.

The Shopping Center Owner has may have encumbered the shopping center with lease exclusives and prohibited uses. It is critical that the Pad Sale REA contain an exhibit listing these exclusives and prohibited uses and requiring the Pad Owner and Pad Tenant to comply with these exclusives and prohibited uses, with the exception that the Pad Tenant would not be subject to exclusives and prohibited uses that relate to leases or agreements entered into after the date of the Pad Tenant lease. The Shopping Center Owner must continue to have a remedy against any Pad Tenant (other than, as stated above, a Pad Tenant with a lease that pre-dates the date of the exclusives and prohibited uses) that violates these exclusives and prohibited uses that were in effect as of the date of the Pad Sale REA.

9. Existing Leases at the Shopping Center Property.

The Shopping Center Property Owner will have entered into leases that pre-date the sale of the Pad Property to the Pad Owner. Many of these leases will contain provisions (aside from the exclusives and prohibited uses discussed above) that could be violated by the Pad Owner. For example, a major tenant lease at the Shopping Center Property may prohibit sidewalk sales or parking lot sales anywhere in the shopping center. It is imperative that the Pad Sale REA reference all of the leases encumbering the shopping center and provide that the Pad Owner will not violate any of the terms of these leases that relate to the Pad Property. The Pad Sale REA should provide the Shopping Center Owner with the right to prevent these unauthorized uses by any legal and/or equitable means, and that the Pad Owner will cooperate with the Shopping Center Owner to take any such actions reasonably requested by the Shopping Center Owner (including the filing of a lawsuit) to curtail any such violations. The Shopping Center Owner may need to provide copies of these leases (with economic terms redacted) to the purchaser of the Pad Property so that it can review them to determine if any such provisions exist.

10. Covenants Running with the Land, Term and Amendments. The Pad Sale

REA should specifically provide that the rights and obligations set forth in the Pad Sale REA “run” with the land of the property subject to the Pad Sale REA. In other words, any person or entity that owns the property subject to the Pad Sale REA will be subject to the terms and provisions set forth in the Pad Sale REA. In addition, the Pad Sale REA should specifically provide that the provisions thereof run in perpetuity and the method by which the Pad Sale REA may be amended. Typically, the Pad Sale REA cannot be amended without the approval of the Shopping Center Owner and the Pad Owner. However, the Pad Sale REA should be clear as to which parties have this approval right if one party’s property is subsequently subdivided into multiple parcels or owned by multiple parties.

As is obvious from the discussion above, the sale of a pad in an operating shopping center raises many critical issues (only some of which are addressed in this article) that must be addressed in the Pad Sale REA. Unfortunately, many Shopping Center Owners and Pad Property purchasers fail to recognize the complexities of these issues, leading to numerous problems after the sale.

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