

Daily Journal

www.dailyjournal.com

WEDNESDAY, SEPTEMBER 10, 2014

Big box closures cause conundrum for real estate lawyers

Landlords and real estate attorneys mull carving up facilities as many sit empty

By Alex Shively
Daily Journal Staff Writer

As the retail industry transforms, real estate lawyers in California are facing a growing number of empty big-box stores. As Internet retailers gain prominence and consumer tastes change, many landlords of large retail centers, who depend on their largest tenants to attract consumer activity to their premises, are finding themselves in the dilemma of having to acquire new tenants for the large vacated facilities. Lawyers throughout the state report a rise in the instances of structural carve-ups as a solution to dealing with the empty big-box conundrum.

According to Oakland-based attorney C. Gregg Ankenman at Wendel, Rosen, Black & Dean LLP, big-box carve-ups have gone from rare events to common procedures.

"For a long time there was not a whole lot of change for department stores," Ankenman said. "They were successful and the customers kept coming."

Allen Matkins Leck Gamble Mallory & Natsis LLP partner Drew M. Emmel, who manages the firm's Orange County office, said he has worked on multiple carve-ups in the past two years, including two in Northern California.

"In both cases," he said, "we were able to find a grocery store that could come in. Then there is all this extra space. It could have just gone to waste but we were able to carve out additional shops."

Ankenman said he handled the carving up of a Super Kmart in Oakland a few years ago.

"We were able to get a Home Depot, but even that was too small for the building. So then we brought in a 24 Hour Fitness and

a McDonald's," he said. "It was a tricky situation because these companies are very used to getting their way. In this case, they had to negotiate with each other."

Century City-based Freeman, Freeman & Smiley LLP partner Glenn T. Sherman, who has advised on many carve-ups, said the solution is becoming more commonplace because of a host of economic and consumer factors.

"It could be that you have a Home Depot or Lowe's that wants to get out of a standard big box and go to a super big box," he said. "Some retailers, like Office Depot, have been really downsizing. The new ones are really small because they think that they can stop offering large bulky items that are hard to drive home with or because they think that they can't compete with online sellers for a certain product."

Ankenman described the impact of pressure from online retailers.

"At some point it wears down the brick and mortar stores," he said. "This is particularly true for the entertainment retail market. Tower Records and Borders had to go out of business because they couldn't stay afloat in the new landscape."

Sherman said that having a big-box go empty is bad for everybody.

"The building is an eyesore," he said. "If it was located in a satellite community or small town, the whole community could become less attractive to other businesses and the downward spiral begins."

Sherman sees the flight of the big-box occupant as a signal to the landlord to start getting a new plan in place as quickly as possible.

"They can try to replace the tenant with another large retailer," Sherman said, "but, depending on the square-footage, that might be difficult."

According to Emmel, changes in consumer tastes have made it harder to find a replacement for a vacant big box.

"When my client sees their big box go empty," Emmel said,

"I advise them to immediately start thinking about a carve-up. In most cases it's best to move on rather than think that a replacement tenant can be found for these large facilities."

Emmel judged that the best option for landlords is to carve the facility up and fill it with recession-proof retailers.

"Occupants such as gyms, grocers, or storage space operators are likely to stick around," he said.

Carving the space up is not an ideal option because while the former big-box retailer itself often paid a lower rent than the average complex tenant for their ratio in square feet, the difference was more than made up for by the spike in rent that the landlord took in from the smaller shops who wanted to be located near the big box. If the big box is carved up, the smaller retailers find their location less attractive to consumers and will not stay at the same rent level.

Ankenman said that developers, landlords, and prospective tenants are looking to plan ahead more than ever.

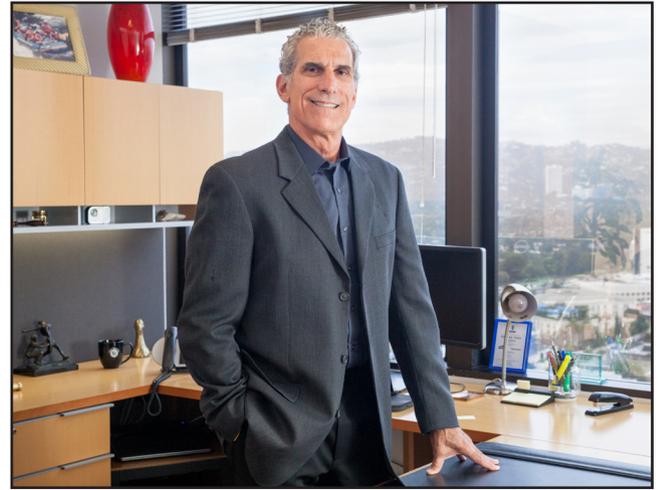
"Now, developers will not build a big box on speculation," he said. "They are lining up tenants and in some cases they won't even sign deals with smaller surrounding shops until they have the anchor signed up first."

He also noted that co-tenancy agreements, which reduce the rent of smaller retailers in the event of big-box vacancy, have become a more contentious element in negotiations.

"There is anxiety among the surrounding small retailers," Ankenman said. "They are now more likely to call for an agreement."

For their part, landlords see the risk and are less likely to want to bind themselves in this way. Ultimately, the higher leverage of the landlords and the lenders, which also might oppose co-tenancy agreements, has been winning out.

"I would estimate that there are overall fewer of these agreements," Ankenman said.



Alexander Drecun / Special to the Daily Journal

Glenn T. Sherman of Freeman, Freeman & Smiley LLP has advised on a number of big-box retail carve-ups.

Even if the landlord can keep his other tenants and avoid a hit on the rent, following through on the carve-up presents many more challenges.

"The major problem," Sherman said, "is when you find that your facility does not lend itself well to being carved up. If the store is a very deep box, that is, the space extends too far back from the front, then it can be hard to utilize that space or attract new tenants."

Sherman points out that his clients have found storage space operations to be a good use of awkwardly situated room at the rear or fringes of facilities.

Yet even if a storage facility is recruited, friction can emerge over shared responsibilities. Many landlords favor a triple-net lease wherein the tenants pay a part of the collective utilities, upgrades and insurance.

"In the case of a storage facility," Sherman said, "it can be hard to make the case to the tenant to engage in a triple-net lease, when their operations do not require as many fixes or use as many utilities as the other tenants."

While gyms are another popular option with the landlord, their introduction has frequently irked surrounding tenants.

"It has also been said that gyms

are a poor use of big box space," Sherman said.

The point of contention is the fact that many covenants, conditions and restrictions agreements or CC&R's, place limitations on the number of parking spaces that one business can occupy.

"When you bring in a gym, sometimes you can have a parking lot that was not designed to accommodate a large number of vehicles. It fills up quickly to the disadvantage of other tenants," Sherman explained.

To appease the disgruntled shops, the landlord will sometimes attempt to amend the CC&R or at least limit a particular section.

"Usually the owner will have to make certain assurances," Sherman said, "about not having the gym in a particular place or placing restrictions on parking for certain areas and times."

Compliance can be another major stumbling block in the carve-up.

"When there are changes to the structure you will have to meet new compliance code," Sherman said. "Sometimes the owner can have the new layout easily grandfathered into code compliance, but if not, they might have to make costly additions to meet the fire safety and other occupancy obligations."