

Mixed-Use Projects: Document and Development Challenges

By **Steven P. Heller, Esq.**
and **Sheldon A. Halpern, Esq.**

Most real estate experts will agree that developing commercial real estate projects is challenging even in the simplest of circumstances. And, going a step further, mixed-use projects present the developer and its attorney with an additional level of difficulty.

A mixed-use project is a commercial real estate development that contains at least two uses among residential, lodging, retail/entertainment and office. Some mixed-use developments are contained within a single building (“vertical”) and others are spread out in different buildings within a unified project area (“horizontal”).

The mixed-use concept may not be new, but a contemporary assortment of constraints and market trends is driving the development of current mixed-use projects such as the decrease in available land for development coinciding with increased interest in live/work urban spaces. From a marketing perspective, mixed-use projects create synergy; for example, a retail/residential center provides residents with convenience while helping to provide a market for the retailer that can “count rooftops” by looking up at its own roof. Financially, mixed-use projects may reduce risk because a center with multiple product types may be less susceptible to market fluctuations that would affect any single product type.

Of course, many matters that developers need to account for in developing a mixed-use project are the same as those for a

single-use project. But, because different uses have varying needs that impact upon each other, the developer must reconcile the parties’ competing interests and the developer’s attorney must document such reconciliation. This article addresses some of the unique development issues that confront a developer of a mixed-use project and focuses special attention on issues that may arise when a vertical project is built above one or more already-operating retail stores.

Legal and Governance Approaches

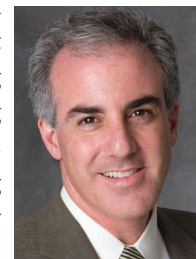
The uses in a mixed-use project may change with a frequency that might make static zoning designations impractical. Accordingly, mixed-use developers seek flexible, special-district zoning so that the developer does not need to continually seek variances to accommodate changes among differing types of potential buyers and tenants.

Developers and government agencies sometimes work out symbiotic relationships to fit the unique characteristics of a mixed-use project into standard governmental requirements. For example, peak usage times for movie theaters and office buildings occur at different hours and days, so a government agency addressing a project with these mixed-uses may be willing to reduce a developer’s overall parking requirements. Convincing anchor retailers who are accustomed to traditional parking ratio requirements may be a challenge for the developer and its attorney.

The internal governance of a mixed-use center also poses challenges that might not arise when crafting legal documentation for a single-use center. When a developer’s attorney prepares governing documents for a mixed-use center (such as a reciprocal easement agreement (“REA”)), the attorney needs to determine the most efficient and flexible way to jointly govern diverse uses, including allocation of decision making among different types of owners and users. Developers should consider using different documents to govern different user categories, whether grouped by use, location or otherwise. Some projects may require two, three or more REAs, depending upon the complexity and needs of the particular project.

For example, a multi-party REA that sets forth the easements and otherwise provides the foundation for a mixed-use project could be entered into by the developers of the retail, office and residential portions, the anchor retailers and a redevelopment agency that is providing financial assistance with

Continued.



Steven P. Heller is a partner at Gilchrist & Rutter in Santa Monica, Calif. His practice focuses on commercial real estate and business transactions. Contact him at sheller@gilchristutter.com.

Mixed Use Projects *continued 2*

parking facilities. A three-party maintenance and operation agreement could be entered into among the retail developer, the office developer and the anchor retailers to flesh out use and operation requirements that are of particular interest to such parties; consent to changes would not require input from the residential or governmental parties. A development agreement among all parties could deal with the initial development, including scheduling and any special phasing/staging arrangement that may be required if the anchors will operate during construction. The residential interests are typically represented in the REA documents by a residential developer; after the condominium or housing units are sold, the residential interests are typically represented by a condominium or housing association (not individual owners).

Construction

Building issues and costs among different types of mixed-use projects can vary widely, especially when the center is vertical. Minimizing interference with existing users while building new improvements can create headaches and increase costs. The most difficult issue to be agreed upon may be the provision of sufficient parking. In some instances, the existence and operation of one occupant increases construction costs for another occupant. For example, a supermarket may need to take on the increased cost of constructing underground parking because of requirements relating to residential units above it, while the construction cost of building the housing may be impacted by the need to design and construct appropriately sized units that are structurally and architecturally consistent with the preservation of the market's standard dimensions. Because supermarket customers might not be used to parking underground (and taking underground shopping carts filled with food), operational challenges may arise as well.

Legal requirements for some uses are different from those for other uses, so a developer constructing a mixed-use project may also face inconsistent or overlapping requirements. Fire code or other safety regulations may require multiple lobbies or exits based on certain types of businesses in the center that draw many customers or have large numbers of building occupants, which otherwise might not be required for the other owners or tenants in the center. The co-existence of diverse uses may trigger multiple requirements for matters such as handicap access or access to parking spaces. In allocating these responsibilities and costs, the developer may encounter resistance if it attempts to spread them among all occupants or to assign them only to the users triggering the requirements. These situations will call for creative negotiating approaches.

Construction also creates noise and other inconveniences. Major construction work that occurs during the busiest retail periods of the year (e.g., October - December) should be subject to the anchor retailers' approval and, perhaps, the right to require the delay of that work. Correspondingly, construction work at centers with existing residential or office components should (for residents) avoid late night or Sunday work and (for office users) minimize work during the business day. Parties may undertake some sort of dispute resolution process to work out disturbances among different users.

Expenses & Taxes

In a single-use center, occupants typically share costs under a relatively simple formula pursuant to which each user pays its pro rata share. But in mixed-use centers, different types of uses result in a range of types and amounts of costs for various items. Some users may use certain services or utilities exclusively (or at disproportionate levels). For example, condominium residents do

not use the same volume of utilities that a restaurant uses. Residential users may exclusively use a separate elevator or lobby area that is located within a retail facility. Diverse users might not accept equally shared payment obligations when equal sharing results in inappropriate or unfair allocations.

Developers often need to formulate alternative models for percentage share allocations or create separate cost pools that allocate specified costs only among like users. Calculations for allocating these sorts of expenses can be based upon a variety of metrics, including square footage, parking spaces, specific usage variables and fixed amounts subject to escalation. Separately metering utilities for specific users avoids disputes but may not always be feasible.

With regard to taxes, developers should arrange, if possible, for a separate assessment of discrete uses and parts of a mixed-use center, so that each user is responsible only for its own taxes. Absent separate assessment, an increase in property taxes for one set of users, can impact others. For example, a Proposition 13 increase resulting from the sale of the office portion of a mixed-use project could impact the tax obligations of the retail anchors, who may pressure the developer to indemnify them. They may also seek protection from assessments attributable to Mello-Roos or other special assessment districts formed to construct required infrastructure.

Parking Issues

Parking arrangements common for single-use projects often do not suffice for mixed-use projects. Parking rules and regulations must address the varying timing, volume, security and access needs of diverse users. For example, office users typically pay for parking rights, but retail users frequently park for free. If office parkers are left unregulated, they may poach on the free

Continued.

Mixed Use Projects *continued 3*

retail parking areas; or, in other circumstances, retail customers may mistakenly park in spots intended for exclusive use by residents. Documenting decision making as to future changes in parking charge structure can be a real challenge.

A mixed-use project can utilize separate parking structures and/or separate access ways to ensure that different categories of parking users are properly served. Alternatively, a developer can regulate shared parking areas as follows: by marking signage in appropriate sections of the parking facility, by effectively marking individual spaces, or by providing for individual identification stickers or access keycards for designated areas. Creative parking arrangements will require careful enforcement, adding another layer of cost allocation issues.

If parking structures are constructed with the use of Mello-Roos or similar bonds, the issues multiply. The governmental authority will, to satisfy bond counsel, need to require that parking remain open to the public and, at the same time, preserve the flexibility to change to a non-parking use. Similarly, the governmental authority will need to have the right to institute parking changes. Trying to convince anchor retailers that they have no control over these decisions is a Herculean task.

Developing a mixed-use project also complicates the calculation of required parking ratios because different ratios apply for various uses. Developers that build in sufficient flexibility can switch ratios among users, when necessary, while maintaining required ratios that apply to specific parcels or to the overall project. A minimum number of aggregate spaces, in lieu of ratios, may work for some projects.

Use and Design

Developers of mixed projects need to balance uses so that the protection of residents, or of

an appropriate office environment, does not overly restrict the developer's ability to successfully market and lease retail space.

Some issues relate to basic project design. Developers obviously need to attend to the needs of diverse users with regard to noise, smoke, and the placement and allocation of parking and access. Soundproofing is vital for residents that live above or adjacent to entertainment or retail operations. First-rate ventilation systems are a must for restaurants in projects with residential or office located above or adjacent.

A mixed-use developer must also address more subtle design and use issues. Will different types of users share elevators, parking or trash collection areas, and, if so, how will the various users work together? A retail loading area may need to fit gracefully into a residential or office environment.

Retail and residential owners have different lighting needs, relating to the hours of lighting and the expense of the power for maintaining the lighting. Lights that shine upon other parts of the project may adversely affect other users. Accommodation of multiple uses may require establishment of uniform lighting hours with a process for requesting additional hours. For example, a retailer might make a formal request to shine light upon residential parts of the project at a certain time, with the residential users having the right to reasonably disapprove the request and/or to require the retailer to pay the excess costs of the lighting.

Ultimately, accommodating mixed-uses requires creativity and flexibility among the developer and among the users themselves. To avoid restaurant trash pickups at 3:00 a.m. (consistently awakening residents), restaurant owners and residents need to

come to an understanding. In one instance, a hotel overlooked a central retail area where live music was frequently scheduled; when the hotel was not fully booked, the hotel placed guests in rooms on the opposite side of hotel; when the hotel was fully booked, the retailers agreed to end the shows earlier.

Accommodation of residential areas outside the project may also be necessary. The entitlements for the project may restrict hours of lighting that can be seen outside the project and loading and other noisy activities that can be heard outside the project.

Conclusion

No developer would capriciously choose to take on the burden of solving the various governance, construction and design, cost and use problems raised in this article. But these tangled circumstances are the natural byproducts of the development ingredients that increasingly attract residents, retailers and other users to mixed-use projects. Careful attention to the unique problems of mixed-use centers increases the odds of benefiting from, and not getting defeated by, the natural synergies of mixed-use developments.

Steven P. Heller is a partner at Gilchrist & Rutter in Santa Monica, California.

Sheldon A. Halpern, Esq. is a partner at Pircher, Nichols & Meeks in Los Angeles, California.

This article was originally published in California Centers Magazine, No. 58.