When A Seller Doesn't Want to Sell Everything

By Joshua Stein, PLLC

Great development sites are often owned by people who aren't in the real estate business. They operate some other business on part of the site. They like doing that. They're happy to sell or ground lease the site for development but want to "go back in" when the developer finishes its project. I have recently been involved in quite a few of these projects, including one where I acted as an arbitrator when things went wrong. They are tricky transactions.

A seller might also agree to one of these transactions as a way to reduce the cost to the developer. In substitution for some cash, the developer would instead promise to deliver back to the seller some retail space or a couple of floors of office space.

How do you define what the developer has to deliver? The seller has to think of everything. If it's not in the specs, it won't happen. So the seller needs to think through, with competent professionals, exactly what they need to receive from the transaction. If they can, they'll define it in precise detail and make the developer deliver exactly that.

But things change during construction. Problems come up. The developer will want to move walls around, reconfigure utilities, change entrances, lower ceilings. Can they do it? Somehow every one of these changes seems likely to diminish what the seller will ultimately get, so the seller will want to be able to stop them. But the developer wants flexibility.

At the end of the day, what if the developer delivered more or less than promised? The seller's great new space might have an extra hallway, or might lose some space because a long wall had to be moved six inches to accommodate some pipes. Does the developer get a price adjustment if it delivers more space than promised? Does the seller get more money if the developer delivered less? One could negotiate that, or perhaps negotiate a one-way adjustment only. It depends on the circumstances.

If the parties do negotiate an adjustment because the space delivered varies from the space promised, that introduces a whole new rat's nest: the question of how you measure space. New York City office building owners are famous for the REBNY rubber ruler. "Leasable" space for an office tenant includes some allocation of the landlord's mechanical and other space in the building. So "leasable" space can expand over time, without actually expanding.

If "leasable" space will determine any price adjustment, the parties almost guarantee themselves a debate. Outside New York City, one often sees a similar tool, the Building Owners and Managers Association standards for space measurement. Under these standards, an occupied space that looks like, e.g., 100 square feet can similarly expand based on an allocation of mechanical space – or even slightly shared space – anywhere in the building. A careful seller will try to limit the measurement to actual occupiable space, recognizing that this might mean a higher valuation per square foot. But it can avoid a nasty and complicated dispute.

So let's suppose the parties resolve all these issues and define with certainty what the developer must deliver, and when, and any price adjustments for late delivery, overdelivery or underdelivery. How does the property owner know the developer will actually accomplish any of it? For that, real estate law offers many security and credit support techniques, but they all ultimately entail litigation if the developer doesn't perform. And some require payment of significant taxes at the outset.

Even worse, the developer might fail so badly that the developer's lender forecloses on the entire project. In that case, will the seller get back whatever they were supposed to get? A lender won't be too interested in hearing about those arrangements unless the property owner had enough leverage and foresight to demand protection.

Finally, at the end of the day, how does it all fit together as a real estate matter? Usually, one of these buildings will involve at least some shared facilities – heat, electricity, mechanical space, etc. The developer and the seller will need to have a regime to run these shared facilities and the building as a whole. Ideally, there won't be too many shared facilities but there are always some.

In most cases, the parties end up creating a condominium, which is relatively routine and unlikely to create problems. But both parties will want to make sure that the terms of the condominium structure are reasonable and balanced and make sense to both parties.

These deals aren't easy to make, but they do get made. They take longer and cost more than anyone ever expected. In retrospect, a seller might wish they had simply decided to relocate, but that's not always an option.

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