LEPATNER REPORT

WINTER 2005 FOR THE DESIGN, CONSTRUCTION AND REAL ESTATE INDUSTRIES VOLUME 24, ISSUE 4

AIR RIGHTS: WITH WHOM TO NEGOTIATE FOR THEIR PURCHASE

David N. Esterman, Esq.

When land is scarce and property is expensive an owner and/or developer of real estate strives to develop a building to its fullest potential. In densely populated and construction-rich locations in urban areas such as New York City, development is often affected and limited by the square footage permitted by local zoning resolutions ("Zoning Resolution"). The Zoning Resolution dictates the maximum height and square footage of a building sought to be built from the ground up or possibly expanded from a pre-existing structure, both of which may be dependent upon or limited by its neighboring owner, or perhaps, the neighboring owner's existing building.

The height and size of any building in the City of New York is determined by the floor air ratio ("FAR")[1] of the zoning lot[2] upon which it is being built. FAR, as defined in the Zoning Resolution, is "the total floor area on a zoning lot, divided by the lot area of that zoning lot. (For example, a building containing 20,000 square feet of floor area on a zoning lot of 10,000 square feet has a floor area ratio of 2.0.)"[3] Conversely, "[a] building can contain floor area equal to the lot area multiplied by the floor area ratio (FAR) of the district in which the lot is located."[4] Thus, a building to be constructed on a 10,000 square foot lot in a zoning district with a FAR of 10.0 could contain 100,000 square feet (10 x 10,000 s.f.) of floor area. Similarly, a building on a 6,000 square foot lot in a zoning district with a FAR of 6.0 could contain 36,000 square feet of floor area.[5] Accordingly, the maximum physical volume of buildings is determined by the relation-

continued on page 2

CONSTRUCTION MANAGER OWNER AGREEMENTS: BEWARE

Alex F. Ferrini, Esq.

A major component of any owner/construction manager agreement ("CMA") is the allocation of risk between the parties for cost over-runs and delays in the completion of a project. At LePatner & Associates, we have recently observed an increasing sophistication in the attempts of construction managers to limit their exposure to liability, while maintaining their right to seek additional compensation from the owner. This trend, in itself, would not be particularly surprising except for the concurrent movement among construction managers to market and hold themselves out as quasi-professionals. In other words, construction managers these days seem to be selling one thing, but negotiating for another. This article will briefly highlight some of the issues that any owner should consider when preparing and negotiating a CMA in order to ensure a fair agreement.

Modern construction managers offer a wide array of sophisticated services to their clients. They sell those services by promoting their ability to deliver an "on-time" and "on-budget" project. During the pre-construction phase of a project, they work closely with an owner and its design team to provide, among other things, site and constructability reviews, schedule reviews, and budget and cash-flow analyses. Based on the con-

continued on page 3

AIR RIGHTS: With Whom to Negotiate for Their Purchase

The air rights over the Hudson Rail Yards are a major prize in the West Side Redevelopment Plan bidding wars.

ship between the amount of usable floor area and the applicable zoning lot, which relationship varies depending upon a multiple fixed by the Zoning Resolution. In fact, Article II, Chapter 3 of the Zoning Resolution provides, in various tables, for any building on a zoning lot, the open space and floor area regulations and limitations for the City, including the minimum required open space or open space ratio, the maximum lot coverage and the maximum floor area ratio.

Sometimes, however, a developer wants to erect a building with a FAR greater than what is permitted by the Zoning Resolution. In such event, a developer can seek a variance to build beyond the "as of right" maximum volume established in the Zoning Resolution. One way to recoup the deficiency in the total floor area and obtain the required variance, is to acquire and develop the unused and undeveloped "air rights" of an adjoining lot owner. The air rights are part and parcel of real property, just as are minerals located in the soil, both of which can be sold to the highest bidder, while retaining ownership of the land upon which they are located. These air rights are generally purchased from the adjoining lot owner, and in some situations, for tens of millions of dollars, depending on the location and value of the development project. Indeed, recent estimates have valued the air rights above the rail yards sought to be utilized for the proposed Jets Stadium on the West Side of Manhattan in the neighborhood of $400-600 million dollars.[6]

While a deal can generally be struck between a developer of one zoning lot and the owner of an adjoining lot for the latter's air rights, just like any other real estate transaction, trouble can arise when a developer seeks to purchase air rights from an adjoining lot owner who has entered into a long term ground lease for the space. This could severely limit the ability of the developer to meet its maximum physical volume for its project. However, under New York's evolving case law, a developer may not be as limited as it thinks by its neighbors. The relevant question becomes, who owns the air rights (the neighboring owner or its ground lessee ("lessee")) for purposes of selling them to a developer, and thus, with whom does the developer negotiate for those valuable air rights.

As is typical with issues of ownership, there is no definitive answer on who "owns" the rights to sell, and it often depends on the facts surrounding each circumstance. The courts have provided some guidance by making use of general themes as to who the stronger party is with the power to sell the valuable rights to an awaiting developer. Other considerations include applicable zoning regulations that may require the neighboring owner to obtain its ground lessee's consent, as an interested party,[7] to sell the air rights, especially where the neighboring owner did not reserve its ownership of air rights in the ground lease.

It behooves a fee owner of real estate to specifically reserve its air rights when entering into an extensive ground lease, otherwise the lessee may be in the driver's seat to negotiate with a developer seeking to acquire the lessee's building's air rights. The Court of Appeals has held that the net lessee was entitled to "full utilization of air space rights" where the net lessee owned the adjoining buildings pursuant to the Zoning Resolutions then in effect.[8] The Court specifically referenced the lack of a provision in the ground lease precluding the ground lessee from exercising rights under the Zoning Resolution, and thus, the ground lessee had not overstepped its bounds.

Notably, in light of the fee owner's failure to reserve air development rights, the concurring opinion in *Newport Assocs., Inc. v. Solow* found that no restriction existed preventing the net lessee from "exploiting the otherwise unused air development rights of the leasehold."[9] The opinion further stated that "under the ordinance it was possible for either the owner of the reversion or the holder of the long-term leasehold, whoever first acted, to use the same air development rights to the exclusion of the other."[10] The message is loud and clear: A fee simple owner needs to specifically reserve its rights with respect to air development rights to avoid a lessee's infringement use.

The Court of Appeals again addressed air rights in a situation where a space tenant (not a net lessee) rented 95% of a building.[11] The Court referenced an ubiquitous "bundle of rights" that run with the ownership of land, and included the air rights appurtenant thereto, instead of being incidental to the ownership of the buildings thereon. Thus, the owner owned and controlled the air and the ability to negotiate its sale to a third party. The Court also made specific reference to the axiom that the owner of the soil, owns the sky above it. Other than the "soil" and the "sky above it," other rights likely to be included in the so-called "bundle of rights" are the rights to use the structures on the land, a right of first refusal to purchase the land, and any development rights.

New York State's Appellate Division has weighed in on the issue of "ownership" of air rights in the context of the zoning regulations then in effect. In 1985, in a situation where the owner of 13 lots was seeking to merge them into one lot, the Appellate Division held that the lessee had air rights to the property during the term of its lease, but not the power to transfer those rights, where the period of the lease was less than 75 years (a require-

continued from page 1

ment of the then existing zoning regulations[12]).[13] The Appellate Division seized the opportunity to re-address the Court of Appeal's *Newport* decision taking it to mean that "so long as no one had exercised the air rights, each was free to exercise them and to build to the maximum height allowed by law. . . . In short, the laurel wreath went to the one first to exercise the right."[14]

Notably, since the Zoning Resolution has eliminated the requirement that 75 or more years on a ground lease entitled the lessee to the utilization of the air rights, the lessee is now in a better position to argue for its alienation of air rights. The result will undoubtedly lead to a revisiting of the Court of Appeals *Newport* rule, as clarified by the Appellate Division in *873 Third Avenue Corp.*, i.e., "first come, first serve." Thus, a developer seeking to acquire air rights from a neighbor will have to contend with the possibility of having to wait while the neighboring owner obtains its lessee's consent, unless the ground lease specifically reserves the land's air rights to the fee owner. Otherwise, the seeker of the air rights could have to wait for a possibly contentious battle to be waged by the fee owner and its lessee for the valuable (and potentially costly) laurel wreath.

[1] See Zoning Resolution of the City of New York, §12-10.

[2] Id.

[3] The lowest FAR in any district is 0.5; the highest basic FAR is 15 in the highest density office districts. In certain districts, the basic floor area ratio permitted on a lot can be increased if certain public amenities are provided.

[4] See http://www.ci.nyc.ny.us/html/dcp/html/zone/zonetod.html.

[5] Id.

[6] MOBILIZING THE REGION, A Weekly Bulletin from the Tri-State Transportation Campaign, Number 452 (March 29, 2004) (http://www.tstc.org/bulletin/20040329/mtr45205.html).

[7] See endnote 1.

[8] *Newport Assocs., Inc. v. Solow*, 30 N.Y.2d 263 (1972).

[9] *Id.* at 268.

[10] *Id.*

[11] *MacMillan, Inc. v. CF Lex Assocs.*, 56 N.Y.2d 386 (1982).

[12] In 1977, the Zoning Resolution was modified and the 75 year or more lease requirement for a ground lessee to exercise its alienation of air rights was abolished.

[13] *873 Third Avenue Corp. v. Kenvic Assocs.*, 109 A.D.2d 489 (1st Dep't 1985).

[14] *Id.* at 492.

CONSTRUCTION MANAGER AGREEMENTS...

continued from page 1

struction manager's reviews, and its knowledge of the local construction market, the CM will make a panoply of recommendations to the owner and the design team intended to facilitate the smooth construction of the project. Thus, the construction manager becomes an integral part of the owner's team by helping to develop a plan that meets the owner's schedule and budget goals. During the construction phase, the construction manager assumes the responsibility of overseeing the construction work to ensure that its plan is carried out. It is the construction manager's expertise and experience in all of these tasks that justifies its fee.

Yet, despite their participation in the review and planning process, and despite their professed level of expertise, construction managers vigorously attempt to unduly limit their liability, thus placing the onus on the owner to pay for delays or other unanticipated costs not associated with any change in the scope of the project. This tension is evident throughout the terms of any CMA. As a result, owners and their counsel must be sure to employ careful and thorough drafting techniques to avoid potential pitfalls.

Construction managers are typically compensated for their services and expenses through a number of mechanisms. First, of course, they are paid a fee, generally intended to cover the construction manager's profit and indirect overhead on the project. Second, they are paid for their "general conditions", i.e., the actual costs they incur in managing the project (e.g., the cost of field personnel, site offices, etc.) and insurance. Lastly, the construction manager is reimbursed by the owner for the actual costs of construction (i.e., the costs of the trade contractors actually performing the work). Even without regard to any potential schedule or cost overruns, owners should carefully examine the allocation of expenses among these three categories to ensure that they are not paying twice for the same service. In contemplating potential problems on the project, owners should be cautious to understand how authorized change orders or extensions of time will affect the construction manager's fee and general conditions. It will be natural for construction managers to attempt to add additional profit and overhead expenses to any such authorized change. Conversely, absent any authorized change, owners should be aware of attempts to include acceleration costs or charges for "extra work" in general conditions line items.

Often, to circumvent other restrictions in the CMA, construction managers will attempt to negotiate the creation and terms of use of a "contingency" fund to cover increased costs not associated with a change in the project scope. Such funds were originally conceived as rainy day accounts for owners to help pay for desired scope changes, or those coordination and clarification issues that inevitably present

Continued on next page

OWNER BEWARE...

continued from page 3

themselves over the course of construction for which the owner would be otherwise liable. We have, however, recently seen contingency provisions proposed by construction managers that would remove all owner discretion from any use of the contingency. In other words, if such a provision were accepted, the contingency would become nothing more than a fund from which the construction manager could pay for its mistakes in estimating either the cost or the schedule of the project. The owner would then be forced to increase its project budget for any unanticipated owner expense. Of course, an owner may agree to allow the construction manager some access to additional funds to address field issues not properly anticipated at the outset of the project. Such access, however, should be closely monitored and controlled by the owner, and should be tied to any savings clause or bonus that may be awarded to the construction manager at the end of the project.

The Owner must also be aware of the change order procedure and the construction manager's expected use of change orders to secure more compensation. While it seems axiomatic that owners will not be obligated to pay for un-authorized change orders, we have seen CMA provisions that purport to put the onus on an owner to dispute or otherwise reject a change order request. Absent such dispute or rejection, an owner may be deemed to have accepted the request. Thus, owners should examine the prospective change order provisions of any CMA with a view toward realistically estimating the required level of project oversight.

The flip side of a construction manager's attempt to have funding flexibility will be its efforts to limit its liability in the event of any cost or schedule overrun. Typically, these efforts will take the form of a proposed mutual waiver of consequential damages, a proposed limit on damages available from the construction manager (or its insurer), or both. The concept of a "mutual" waiver may be deceptively attractive. Because of the respective nature of their damages in the event of a delay on the project, such a waiver will tend to favor a construction manager over an owner, despite the purported mutuality. The owner, therefore, should only consider such proposals when combined with further protections against any construction manager claims or provisions that will allow the owner some recovery for its financial losses in the event of delay.

...CONSTRUCTION MANAGERS VIGOROUSLY ATTEMPT TO **UNDULY LIMIT THEIR LIABILITY, THUS PLACING THE ONUS ON THE OWNER** TO PAY FOR DELAYS OR OTHER UNANTICIPATED COSTS NOT ASSOCIATED WITH ANY CHANGE IN THE SCOPE OF THE PROJECT.

In sum, the risk allocations in any CMA should be openly negotiated to arrive at mutually acceptable provisions. Owners should be willing to pay a fee commensurate with the construction manager's qualifications and abilities as a firm as well as the respective experience of the CM's proposed project executives, managers and superintendents. Conversely, construction managers should be willing to assume the risks inherent in the responsibilities with which they are entrusted. In order to ensure such mutuality, and to realize the benefits of the fee paid to a construction manager, owners and their counsel must be careful to fully examine the interplay of all of the various provisions of any proposed construction management agreement.

FIRM NEWS

When the Lower Manhattan Development Corporation awarded the design commission for the Performing Arts Center at the Freedom Tower and World Trade Center site to Gehry Partners, the Gehry firm turned to LePatner & Associates to negotiate the complex design agreement on their behalf with LMDC. The Project, expected to cost between $250-400 million, includes venues for both the Joyce Theater International Dance Center and Signature Theater Center.

LePatner & Associates has been retained by Milliennium Partners, one of the nation's preeminent real estate developers, to draft and negotiate construction agreements for several exciting large projects, including a new high-rise in Battery Park City, and a large mixed-use project in San Francisco.

LePatner & Associates represents the owner of a townhouse, previously owned and renovated by world renowned architect, Paul Rudolph, in litigation against his next-door neighbor. In a trial now proceeding in Supreme Court, New York County, LePatner is arguing for the right of its client to access the neighboring property in order to repair and renovate the exterior facing the neighboring property. The neighbor continues to refuse access to its property and even built a new wall blocking access to our client's exterior. The neighbor has now violated an emergency declaration by the Department of Buildings to dismantle the new wall. While LePatner has litigated unique disputes before, this one may top the list.

QUOTE OF THE QUARTER

The point of living and of being an optimist is to be foolish enough to believe the best is yet to come.

- Peter Ustinov

LEPATNER REPORT
IS A PUBLICATION
OF THE LAW OFFICES OF
LEPATNER & ASSOCIATES
600 LEXINGTON AVENUE, 21ST FLOOR
NEW YORK, NEW YORK 10022
(212) 935-4400
MAIL@LEPATNER.COM
WWW.LEPATNER.COM