AIR RIGHTS DEVELOPMENT

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PART II

Practical Use of "Air Rights"

In *Part I* of this series, the legal foundation for "air rights" development was introduced. The following hypotheticals illustrate practical examples of air rights development.

As discussed in Part I, air rights development is a combination of black letter real estate law and the applicable zoning code of the community in which your property is located. Because zoning codes are legislative pronouncements, they are subject to change as local municipal governments determine appropriate. For this reason, the current zoning classification and its attributes for every project, and certainly for any project involving air rights development, must be examined as part of the due diligence investigation.

The following hypothetical facts and scenarios are for illustration only. They are not intended as legal advice and may not be relied upon as such.

***Hypothetical Facts*:**

Suppose you are planning to acquire a 20,000 square foot parcel in Chicago, Illinois zoned DC-12 or DX-12. Your purchase price is $7,500,000. You believe it is a perfect location for a restaurant and entertainment complex serving food and liquor, with live entertainment and dancing. You visualize a state of the art venue spread out over 2 floors, with about 18,000 square feet of usable space per floor, for a total restaurant and entertainment venue of 36,000 square feet. For simplicity of illustration, assume you can build to the lot lines.

Fortunately, adequate parking is close by and available. Demand for retail, offices, and apartments is growing in the vicinity of your parcel, which you believe will further enhance the chances of success of your planned business by bringing more customers through your doors. Although retail, offices, and apartments represent "hot" development opportunities and might also be an excellent investment, you have no experience or interest in developing retail, or offices, or apartments, and really just want to develop and open your dream restaurant and entertainment complex. You have calculated your costs of construction and operation and believe the project is economically feasible, although you would like to find a way to reduce your costs or otherwise increase your return on investment.

Consider this: The restaurant and entertainment complex you wish to construct is a permitted use in the applicable zoning classification under the Chicago Zoning Ordinance. Also permitted are a wide array of other business and service uses, as well as apartments as long as they are not below the second floor.

The permitted floor area ratio (FAR) for a parcel zoned DC-12 or DX-12 under the Chicago Zoning Ordinance is 12; which means that the total square footage of the building or

buildings permitted on your 20,000 square foot parcel (the “Entertainment Parcel”) is 240,000 square feet. You are utilizing only 36,000 square feet, which means, from a zoning standpoint at least, you are underutilizing the Entertainment Parcel to the extent of 204,000 square feet. If you could sell the right to development that 204,000 square feet without interfering with your planned restaurant and entertainment complex, you may be able to recover a significant portion of your land cost. Almost free money.

How could this work?

Scenario No. 1: With the hypothetical facts presented, it may be possible to market and sell the "air space" above your proposed restaurant and entertainment complex for development as offices and/or apartments, and possibly even retail. As mentioned, under the applicable zoning classification, 204,000 square feet remains available for development on your site. Assume prevailing land values of $375 per square foot (represented by your purchase price of $7,500,000 for a 20,000 square foot parcel). A developer of offices and/or apartments, and possibly retail, may plausibly view your "air space parcel" as a bargain at +/- $4,000,000 ($200 per square foot – measured in two dimensions for 20,000 square feet) since it would still enable construction of 204,000 square feet of floor area above the second floor.

Obviously, to make the "air space" usable, adequate means of access and support must be planned, which will require detailed planning for design and construction of both the ground level development and the "air space" development (which do not necessarily need to be constructed at the same time, although simultaneous construction may be more efficient and practical). Creation of legally sufficient easements of support, and easements (or fee title conveyances) for ingress and egress, utilities, loading and unloading, mail delivery, a street level lobby, elevators, standpipes, etc., would be needed, as well as development specific covenants running with the land to promote non-interference and compatibility of use of each parcel.

While sale of an "air rights parcel" will require added expense for engineering (much of which will likely be undertaken by the proposed developer of the air rights parcel) and attorneys’ fees to negotiate and draft a workable declaration of easements, covenants and restrictions to legally facilitate the development and use of each parcel, the economic advantage of being able to sell the air rights parcel may more than justify the added effort and development expense involved.

Scenario No. 2. Assume the same hypothetical facts as in Scenario No. 1, except that instead of being the owner of the Entertainment Parcel referred to in Scenario No. 1, you own and wish to develop a parcel adjacent to the Entertainment Parcel. Perhaps the Entertainment Parcel has already been developed with the restaurant and entertainment complex referred to in Scenario No. 1. Assume your parcel (the "High Rise Parcel") is 40,000 square feet with a zoning classification that allows a floor area ratio (FAR) of 12 and, for simplicity of illustration, you can build to the lot lines. You wish to construct (or to sell your parcel to a developer to construct) a mixed-use development with first floor retail, two floors of office space, and 9 floors as apartments. Because zoning for the High Rise Parcel allows an FAR of 12, you determine that a twelve-story building (if built to the lot lines) would be 480,000 square feet, the maximum you will be able to construct on your 40,000 square foot lot.

[Note that a stated FAR does not require building to the lot lines. You might also build a 480,000 square foot building on, for example, 60% of the High Rise Parcel, by building a twenty story building (60% of 40,000 sq. ft. = 24,000 sq. ft. x 20 floors = 480,000 sq. feet).]

In conducting your pre-construction due diligence you determine that market demand is high and that if you could add another 200,000 square feet of apartments or other permitted uses, you could generate a substantially greater return on your investment. Still, you are faced with the maximum FAR of 12 for the High Rise Parcel as established by the Chicago Zoning Ordinance.

A possible solution may be the following:

The Chicago Zoning Ordinance defines a "Zoning Lot" as follows: "*A 'zoning lot or lots' is a single tract of land located within a single block, which (at the time of filing for a building permit) is designated by its owner or developer as a tract to be used, developed, or built upon as a unit, under single ownership or control.*"

Therefore, 'zoning lot or lots' need not coincide with a lot of record.

One solution may be to approach the owner of the Entertainment Parcel with a proposal to vertically subdivide the Entertainment Parcel into three sub-parcels (this would require compliance with the Chicago Subdivision Ordinance and may require Planned Development approval). *Sub-Parcel A* would be that part of the Entertainment Parcel lying *above* a horizontal plane located "x" feet (e.g. +100 feet) above Chicago City Datum ("CCD") [the "x-plane"]; *Sub-Parcel B* would be that part of the Entertainment Parcel lying *below* the x-plane and *above* a horizontal plane lying "y" feet below the Chicago City Datum (e.g. -20 feet CCD) [the "y-plane"]; and *Sub-Parcel C* would be that part of the Entertainment Parcel lying *below* the y-plane.

As owner of the High Rise Parcel you might propose that, upon subdivision of the Entertainment Parcel as described above, you would purchase the entire Entertainment Parcel except Sub-Parcel B for a purchase price of $4,000,000, and then include the Entertainment Parcel in a Zoning Lot with the High Rise Parcel; with specific covenants running with the land specifying that the owner of the High Rise Parcel shall control future development of the Entertainment Parcel with a reservation to the Sub-Parcel B owner, and its successors and assigns, of the right to continue to own and operate the restaurant and entertainment complex, and any replacement of those improvement, and to convey or encumber Sub-Parcel B.

The "Zoning Lot" would then be 60,000 square feet [comprised of the 40,000 square foot High Rise Parcel and the 20,000 square foot Entertainment Parcel]. Because the FAR for each remains 12, the maximum floor area on the total Zoning Lot is 720,000 square feet.

Because 36,000 square feet has been used (or is to be used) within the Zoning Lot for the restaurant and entertainment complex (within Sub-Parcel B), 684,000 square feet remains available for development on the Zoning Lot. Remember that the twelve story maximum resulted from application of the FAR of 12, not by a height restriction. Therefore, instead of being able to construct only a 480,000 square foot project on the High Rise Parcel if developed

alone, the developer may now be able to construct a total of 684,000 square feet on the High Rise Parcel – an additional 204,000 sq. ft. [Note, however, that some zoning districts have height restrictions so, once again, it is critical that you carefully examine the applicable zoning ordinance and building codes in all particulars.]

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Of course, if the developer does construct 684,000 square feet of floor area on the High Rise Parcel (in addition to the 36,000 square feet constructed on the Entertainment Parcel – Sub-Parcel B) under the foregoing Scenario No. 2, all floor area available for development of the combined Zoning Lot pursuant to the zoning ordinance will have been fully utilized. As a result, since the Zoning Lot is fully developed as a whole, no further opportunity exists to expand the square footage of improvements on Sub-Parcel B of the Entertainment Parcel. If the restaurant and entertainment complex fails, or is destroyed or otherwise demolished, the replacement improvements will be limited to a maximum square footage of 36,000 square feet.

To avoid this outcome, consider negotiating an "air rights transfer" that raises the elevation of the delimiting x-plane at, say, +200 feet CCD instead of +100 feet CCD, with an express covenant running with the land that reserves to Entertainment Parcel – Sub-Parcel B an additional portion of the potential FAR, for future development subject to applicable zoning approvals and the likely planned development ordinance.

Under Scenario No. 2, the sale of "air rights" is more akin to the sale of "development rights", but the legal principal is substantially the same as in Scenario No. 1. In each case, a property owner is selling the right to develop "the air above" while retaining the ground level development parcel.

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"Air rights" are valuable property rights included in the bundle of rights comprising fee simple title. They can be unbundled and sold, purchased, transferred, and owned separate and apart from other rights in the bundle. Under the right circumstances, "air rights" may represent a substantial untapped resource with great value to those who recognize their potential.