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Workshop Session 14

Co-Tenancy: Tied at the Hip—The Who, the What and the Why

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Introduction:

Co-tenancy clauses can be a powerful tool for a retail tenant to ensure it is not operating alone in what was intended to be a vibrant center. Particularly for new developments, co-tenancy can be used by landlords to assure potential anchor or junior anchor tenants that they will be joined by other complimentary and beneficial tenants. Such clauses might provide that a retail tenant can close ("go-dark"), pay reduced rent, and terminate after a period of time if a certain number and type of stores are not open in the center. Co-tenancy clauses may be demanded by national retail tenants, but present a significant risk for landlords and developers, with unexpected consequences if not drafted carefully. Thus, co-Tenancy provisions can be one of the more heavily negotiated provisions in a retail lease. From a landlord's perspective, the remedies available to the tenant in case of a breach are significant (often a reduction in rent or termination of the lease). Further, co-tenancy provisions represent a landlord making guarantees for conditions that are outside of landlord's direct control. When negotiating and drafting co-tenancy clauses from the landlord's perspective, full consideration should be given to the size and configuration of the center, terms of the leases that are in effect, and potential other delays that could affect the timing of development and construction. Further, a landlord should consider trying to negotiate certain limiting conditions to tenant's exercise of its co-tenancy remedies, such as being open and operating or tenant not being in default.

The Who and Why of Co-Tenancy Provisions:

Retail operators want the best possible shot for success when opening a new location in a shopping center (whether a traditional mall, strip center, lifestyle center or power center). This success often hinges on the center's overall ability to attract customers. Accordingly, retail tenants seek out centers with high occupancy rates, large national or well-known anchor tenants, and the presence of other, complimentary retailers. In order to ensure that a tenant's expectations are met in this regard, retail tenants with greater negotiating leverage (national and large regional credit tenants that are typically highly sought after by landlords) will typically seek to include "co-tenancy" provisions in their leases. This is particularly true when such a retailer is going into a new development, where there are no or few existing retailers currently operating. Because of the importance of such provisions, co-tenancy is often times negotiated at the letter of intent stage of the lease negotiation and then refined further as the deal goes to lease.

Types of Co-tenancy:

As presented above, the particular details of a co-tenancy provision will depend on the negotiation leverage of the parties involved. There are different approaches to structuring co-tenancy provisions, generally they can be categorized into three general types: Delivery Co-Tenancy, Opening Co-Tenancy and Operating Co-Tenancy. Delivery and Opening Co-Tenancies are similar in structure in that such provisions set out certain occupancy conditions which must be satisfied prior to the tenant opening for business in the premises (or earlier upon delivery). An operating or on-going co-tenancy provision sets out occupancy conditions which must be satisfied throughout the term of the lease. Let's look at each type in more detail:

> Delivery Co-tenancy. A delivery co-tenancy is a condition precedent to tenant's acceptance of landlord's delivery of the premises. Such a term is usually only employed in instances where the retail center is not yet constructed. In such a scenario, the retail tenant will want to know that landlord has in fact, entered into valid and binding leases (subject to no conditions other than landlord's performance) and typically may require specific, named operators as "Inducement Tenants". If landlord does not satisfy the Inducement Tenant condition by providing to tenant within a certain time period prior to the intended premises delivery date, proof of signed leases, then tenant would have the option to terminate the lease. The advantage to Tenant of this type of provision is that by addressing the condition in advance of the delivery, tenant avoids certain costs and expenses of construction, fixturing, hiring and stocking of the premises.

EXAMPLE:

"Landlord shall enter into lease agreements with _____, _____, and _____ (hereinafter referred to as the "Inducement Tenants") to open and operate in the locations shown on Exhibit B and such leases shall provide that each Inducement Tenant shall open for business in the designated premises and operate for at least one (1) day for terms commencing simultaneously or prior to the term of this Lease."

Opening Co-tenancy. As the title suggests, an opening co-tenancy requirement is a condition to tenant's obligation to open its store and/or commence paying rent. Again, this type of clause would typically be utilized when the shopping center is a new development, but may also be found in an existing shopping center that is being

redeveloped. Such opening co-tenancy condition could be a minimum square footage threshold requirement and/or that a number of specifically named co-tenants would be open and operating on or before the commencement of the tenant's lease term (e.g. "at least three of the following must be open for business on or before the commencement date: Ross Dress for Less, Kohls, Petco, Ulta and Dicks"). Square footage requirements could be stated as a total of "x" number of national/regional tenants open and operating in "y" square feet or just as a percentage open and operating of the total gross leasable area of the Shopping Center (example: "at least 55% of the GLA of the shopping center"). Specificity in theses clauses can be critical …what constitutes a "national" or "regional" tenant? Is the percentage of GLA calculated based upon what is shown on the site plan or what has actually been built? If you are referencing named tenants on a site plan, make sure they are actually shown on the site plan.

EXAMPLES:

"If upon the Commencement Date, _____ square feet of **[in-line tenant]** gross leasable area is not open and operating **[Alt: If upon the Commencement Date the following named tenants: tenant A (____ sq. ft.), tenant B (_____sq. ft.) are not open and operating]** for retail use within the Shopping Center (the "Co-Tenancy Requirement"), Tenant shall have the right upon written notice to Landlord to (a) delay its opening for business in the Leased Premises until the Co-Tenancy Requirement is met; or (b) to open in the Leased Premises and to pay Landlord Substitute Rent, in lieu of Minimum Rent until the Co-Tenancy Requirement has been satisfied. "Substitute Rent" shall be an amount equal to one half (1/2) of Minimum Rent."

OR:

"The "Initial Co-Tenancy Requirement" shall mean that not less than three Required Tenants occupying a combined total of not less than sixty thousand (60,000) square feet (excluding outlot tenants) shall be open, fully staffed, stocked, and operating within twelve (12) months after the Commencement Date (defined below), within the "Initial Co-Tenancy Area" depicted on Exhibit B. As used herein, the term "Required Tenant" shall mean: (i) a tenant operating a minimum of fifty (50) retail stores, under the same trade name, in at least twenty (20) states; or (ii) a tenant operating a minimum of ten (10) high quality retail stores, under the same trade name, in at least four (4) different states, of the types typically found in first-class shopping centers; provided, however, that a Required Tenant cannot be: (a) close-out retailers such as, without limitation, Big Lots, Odd Lots, and Ollies; (b) single price-point retailers such as, without limitation, Dollar Tree, Dollar Wave, and Dollar General; or (c) in violation of any Prohibited Uses or the Tenant's Exclusive. In the event the Initial Co-Tenancy Requirement is not satisfied within twelve (12) months after the Commencement Date, Tenant shall, as agreed upon liquidated damages and not a penalty, be entitled to abate and retain fifty percent (50%) of Minimum Rent until such time that the Initial Co-Tenancy Requirement has been satisfied. Landlord shall provide Tenant written notice within ten (10) days after satisfaction of the Initial Co-Tenancy Requirement, and Tenant shall resume payment of full Minimum Rent beginning on the first day of the month immediately following the date Tenant receives such Notice."

Ongoing or Operating Co-tenancy. The ongoing co-tenancy requirement typically runs the entire term of the lease and grants the tenant certain remedies if the Shopping Center does not maintain a certain level of occupancy, or if the original named required co-tenants close and are not replaced (by approved replacement tenants). This type of clause will resemble the Opening Co-tenancy clause, and may include that a certain named tenant (a "Key Tenant") must be operating, or designate anchor tenants of a certain class, but will often rely on on-going required number of open tenants or state a percentage of GLA must remain open and operating over time, rather than specific operators or types of retailers.

EXAMPLE:

"Tenant shall not be required to pay Minimum Rent until such time as: (i) a total of twenty-five thousand (25,000) square feet of ground space (excluding the Leased Premises) are open and being operated by other tenants in the Shopping Center ("Additional Tenants"); and (ii) at least two of the Additional Tenants each occupy not less ten thousand (10,000) square feet of ground space. If during the Term of this Lease fifty percent (50%) or more of the leasable space in the Shopping Center (excluding the Leased Premises) is vacant for a for a period of one hundred eighty (180) consecutive days (as applicable, a "Co-Tenancy Failure"), Tenant shall have the right upon written notice to Landlord to reduce Minimum Rent by fifty percent (50%) effective on the last day of the month in which the such notice is received until the Co-Tenancy Failure ends. Tenant shall resume payment of full Minimum Rent on the first day of the month after the Co-Tenancy Failure ends."

Remedies:

As illustrated above, a tenant's remedies for a co-tenancy violation usually fall into three categories: (a) delayed opening; (b) rent abatement; and (c) lease termination.

Delayed Opening: Tenant's requirement to open will be contingent upon the co-tenancy condition being satisfied upon tenant's planned opening date. This usually only arises where there is an opening co-tenancy violation, allowing the tenant to delay the opening and/or rent commencement date. It is easy to see here that one tenant not opening on schedule could cause a chain reaction of co-tenancy failures in a large development. An alternative is to tie the co-tenancy satisfaction to evidence that a tenant is preparing to open (i.e. lease signed, construction commenced, lease contingencies satisfied).

Rent Abatement: In the alternative, Tenant may elect to open, but its obligation to pay rent will be reduced. Typically, a tenant would pay a reduced rent (50% of based rent or minimum rent) until the co-tenancy requirement is satisfied. In these instances, tenant is still required to pay additional rent (i.e. contributions to taxes, insurance, and common area expenses). A more flexible landlord option here would be to provide a window after opening for the co-tenancy provision to be satisfied, such as if the co-tenancy requirement has not been satisfied within twelve months of opening, then tenant has a right to pay reduced rent until that requirement is satisfied. Another option for landlord here is to negotiate a sunset on the reduced rent. For example, if tenant has been open and paying reduced rent for two years and the co-tenancy requirement is still not satisfied, then tenant has the option to remain open and go to full rent, or to terminate the lease.

Lease Termination: Most typically utilized in delivery co-tenancy and opening co-tenancy situations if co-tenancy conditions are not satisfied, but can also be utilized in ongoing co-tenancy situations. Termination for the failure of a delivery co-tenancy condition will still be accompanied with some loss for tenant, usually for architect fees and permitting costs, and a reimbursement of tenant's out-of-pocket costs by landlord should be negotiated into the terms of the termination right. Landlords should negotiate a cure period before termination in any co-tenancy scenario and provide a time period within which the tenant must exercise its termination right (within 30 days following the expiration of the cure period) or tenant's termination right is deemed waived. Occasionally, a lease may provide for a tenant to go-dark if the co-tenancy requirements are not satisfied, with a right to terminate after. The go-dark period may or may not be include an abatement of rent. Even if the tenant is paying rent (and this goes for go-dark provisions in general), landlords should understand that a closed tenant whose lease remains in effect could be worse than a tenant that has terminated its lease (see comments above about interplay of multiple leases with co-tenancy provisions). If the tenant terminates, at least the landlord is then free to fill the space with a new tenant. Accordingly, any such go-dark provision should be accompanied by a landlord recapture right that becomes effective within a certain period of time after the tenant goes dark (and exercised before the tenant reopens. Another consideration for landlord in negotiating termination rights in a co-tenancy situation is whether the landlord has provided the tenant with an initial tenant improvement allowance. If so, the landlord may be able to require that the tenant reimburse it for some or all of the allowance if tenant terminates.

Conditions to Exercise of Tenant Remedies and Other Alternatives: The reason a Tenant needs its remedies for a co-tenancy violation is because they will suffer directly from the result of the loss of activity in the center or project. However, Landlord does have some tools to lessen the sting of co-tenancy failures, including negotiating in a notice and cure period, providing a sunset on payment of reduced rent, including a recapture right if tenant has the right to not open or to close, and requiring the tenant repay some or all of its tenant improvement allowance if it does choose to terminate. Here are some additional landlord positions that may prove helpful in navigating the minefield of co-tenancy requirements:

(a) In order to exercise tenant's co-tenancy remedies, tenant must not be in default under the lease;
(b) In order to exercise tenant's co-tenancy remedies, the tenant must be open and operating in the space (for on-going co-tenancy violations);
(c) Provide that rights or remedies of the tenant as a result of a co-tenancy failure are personal to that tenant, thereby limiting the right to invoke the co-tenancy remedies to the original tenant (not an assignee or subtenant);
(d) For an on-going co-tenancy failure, require that the tenant prove a diminishment in sales during the co-tenancy violation as compared to prior sales periods; and

(e) Provide that the original co-tenancy requirement may be satisfied by a "replacement" tenant in lieu of an originally named key tenant. The definition of what that equivalent tenant looks like should be carefully considered. Some considerations should be:

(i) The size of the premises that the replacement or equivalent tenant is required to lease, whether it is all of the premises of the prior cotenant, or a percentage in the range between 70-90%. Related to this, is whether the closed cotenant space can be replaced by more than just one equivalent tenant or if it can be divided and satisfied by two equivalent replacement tenants. This is particularly important for larger box stores that are listed as cotenants as replacing them can prove difficult.

(ii) If the replacement, equivalent tenant needs to have a certain number of locations, and whether those locations are national or regional. Simply stating a "national tenant" may not be enough when determining what is an acceptable replacement tenant.

(iii) The specific use of the replacement, equivalent tenant. For example, if the cotenant was a grocery store, another anchor or junior anchor tenant may require a replacement tenant also be a grocery store.

Satisfaction of a Condition, Not a Default:

Co-tenancy provisions should be drafted and treated as agreed upon contract conditions, not as covenants or promises that constitute a lease default or breach. Accordingly, if the condition is not met, then the tenant has the options and rights provided in the lease contract. The co-tenancy provision should expressly limit tenant's rights to those stated in the co-tenancy provision if the co-tenancy conditions are not met.

The Courts' View of Enforceability of Co-Tenancy Provisions:

Grand Prospect Partners, L.P. v. Ross Dress for Less, Inc. (Cal. App. 5th Dist.) is a 2015, California case that has been a subject of much discussion in relation to enforcement of co-tenancy provisions. In *Grand Prospect,* the co-tenancy provision allowed Ross to pay no rent at all because of an anchor vacancy, regardless of whether Ross had opened for business, and Ross admitted it was not damaged by the circumstance. Based upon these facts California's Fifth Appellate District held that the rent abatement aspect of the co-tenancy clause was an unenforceable "penalty" because it resulted in a forfeiture disproportional to the range of harm that would be anticipated by a breach. However, in *JJD-HOV Elk Grove, LLC v. Jo-Ann Stores, LLC (Cal. App.3rd Dist.)*, a 2022 California case, the Third Appellate District declined to follow the *Grand Prospect* analysis. The court rejected a similar "penalty" argument and upheld the co-tenancy clause emphasizing the "general rule that courts enforce contracts as written." It is important to note some of the factual differences in the *JJD* case, including the fact that Jo-Ann was paying "substitute" rent based upon a formula negotiated in the contract (rather than a complete abatement). The court found that rather than constituting an unenforceable penalty resulting from a breach of the contract, the co-tenancy clause simply established a condition precedent based upon the shopping center's reduced occupancy, which when triggered, resulted in substitute rent.

A number of recent federal courts have upheld co-tenancy provisions and tenant's remedies in the event of a violation of them, despite Landlord's making various claims of unjust enrichment and breach of lease. Specifically, in Sun Valley, Ltd. v. Galyan's Trading Co., LLC, No. 13-13641, 2014 U.S. Dist. LEXIS 34103 (E.D. Mich. Mar. 17, 2014), the court pointed out that the Lease did not contain specific language about providing an "equivalent" replacement tenant, which the landlord should have negotiated for and included in the lease. An additional case highlighting the importance of carefully defining a "comparable replacement" tenant and what is a "regional" versus "national" tenant is *Staples Office Superstore E., Inc. v. Flushing Town Ctr. III, L.P.,* 933 N.Y.S.2d 732 (2011) debating whether BJ's Wholesale club was a "National retailer".

Additional Clauses Important to Co-Tenancy for a Landlord:

Continuous Operating and Recapture Rights. While national, credit tenants many times demand strong co-tenancy provisions, many are also unwilling to agree to a continuous operating clause. Landlords who enter into co-tenancy provisions should be mindful that they either need to have enforceable operating covenants in their other leases, or alternatively have strong recapture rights in the event a co-tenant closes so that the landlord can quickly regain possession of the space and find alternative or "equivalent" tenants in the time frame required before incurring damages under its co-tenancy provisions.

Percentage Rent Clauses. In leases where a Tenant is paying percentage rent, such a provision should not be affected by the failure of a co-tenancy condition. The co-tenancy provision should clarify that during any reduced rent period, tenant is still obligated to pay full percentage rent. If the tenant is paying landlord a percentage of its sales to the extent the sales exceed a "break point", then the tenant should expressly exclude the sales occurring during the reduced rent period from the calculation of the percentage rent payable when there is no co-tenancy violation, to avoid a double counting of those sales. Conversely, the landlord should stipulate that the break point is reduced in proportion to the period during which the tenant pays reduced rent.

Excused Closures. The lease provisions should expressly provide that closures relating to events of casualty, events of force majeure, condemnation and remodeling should not trigger a failure of the co-tenancy requirement. To limit exposure in such instances, time limits should be established for rebuild after casualty or condemnation and tenant's timeframe for re-fixturing and re-opening in the premises.

Opening Covenant. While many national tenants will not agree to a continuous operation clause, an opening requirement is common. Such provisions may provide that the subject tenant will open for at least one (1) day within the premises within X days of the delivery date. When an opening covenant is agreed upon, a tenant should be mindful, if there is also a co-tenancy requirement, to ensure the terms are not conflicting. If tenant has a right to delay opening if the initial co-tenancy requirement is not met, then tenant's obligation to open should be conditioned on landlord's satisfaction of the co-tenancy requirement.