

Remedies for Co-Tenancy Failure

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As consumers increasingly turn away from the brick-and-mortar store in favour of online retail shopping, commercial tenants are naturally in search of better inducements when entering into leases of retail space in traditional shopping centres. In response to this changing commercial leasing market, shopping centre owners, as landlords, may choose to offer lease incentives to tenants in the form of co-tenancy provisions. These provisions tie a tenant's obligations under a lease to the presence and/or active operation of: (i) one or more "anchor" tenants, meaning a retailer likely to bring in consistent foot traffic (such as a grocery store, big box store or movie theatre), or (ii) a certain minimum number of other tenants in a shopping centre. The delay or suspension of the anchor tenant's operations or the landlord's failure to maintain a certain minimum number of tenants, as applicable, will trigger certain remedies which may include rent abatement and even the option to terminate the lease.

While these remedies are attractive to commercial tenants that may otherwise have hesitated to enter into their leases, they also pose a significant risk to landlords. However, when carefully considered and negotiated, co-tenancy provisions and their associated remedies can be an essential bargaining tool in commercial leasing that can be of benefit to both tenants and landlords, sufficiently incentivizing tenants to enter into a lease while still minimizing potential financial harm to landlords. This paper will first provide a review of the main types of remedies typically offered if a co-tenancy condition is not met, and secondly will discuss specific considerations when drafting co-tenancy provisions. Lastly, this paper will discuss a few recent developments that may influence trends in co-tenancy provisions going forward and into the future.

Types of Co-Tenancy Remedies

The most common types of remedies available to tenants in the event of a landlord's breach of a co-tenancy clause fall into three major categories: (i) rent abatement, (ii) the right to suspend operations or, in the event of an initial co-tenancy, the right to delay commencing operations, and (iii) the right to terminate the lease.¹

Initial Co-Tenancies Remedies

An initial co-tenancy clause provides that the tenant is entitled to certain remedies if the named co-tenant or a certain percentage of co-tenants, have not taken possession or begun operating by a certain date. For example, such date might be the date the benefitting tenant is entitled to take possession of its premises or the date the benefitting tenant is required to start paying rent. Available remedies for the tenant resulting from the breach of an initial co-tenancy clause are as follows:

Delayed Possession Date – The benefitting tenant may be permitted to delay its possession date until such time as the co-tenancy condition has been met. This allows the benefitting tenant to avoid expending funds in upgrading its space before it is confident that the landlord will comply with the co-tenancy clause. Landlords should ensure that this remedy is only available for a short period of time, after which the tenant should be required to either take possession of the premises regardless of if the co-tenancy condition has been met, or terminate the lease. At the time of lease negotiation, the landlord should try to limit the landlord's work to standard improvements or provide that any specialized improvements be constructed

¹ Janet Derbawka, Celia Hitch, Cory Sherman and Laurie Sanderson, *The Show Must Go On: Co-Tenancies in Shopping Centre Leases*, presented at ICSC Shopping Centre Law Conference, Fairmont Royal York, Toronto, Ontario, April 27-28, 2017 [Derbawka] at 2.

after the possession date to ensure that if the lease is terminated early it can quickly be re-leased to another tenant.

Free Rent/Delayed Commencement Date – The benefiting tenant may also be permitted to defer the payment of basic rent or additional rent (with or without a future obligation to repay such deferred amounts) or may have the benefit of a rent reduction until such time as the initial co-tenancy condition is met. The parties may agree to extend the fixturing period or provide free rent after the term has commenced. A landlord may prefer extending the fixturing period so that it is entitled to the benefit of full rent over the entire initial term. As with the delayed possession remedy noted above, landlords should ensure that this remedy is only available for a limited period of time.

Right to Terminate – A landlord or a tenant may have the benefit of a right to terminate the lease if the initial co-tenancy condition has not been met by a certain date. In the event that the landlord's work and the tenant's work have been constructed and leasing commissions have been paid, there will be significant sunk costs to each party. Any reimbursements should be carefully considered when the clause is drafted so both parties are cognisant of their financial exposure in the event this remedy is triggered.

Continuing Co-Tenancies Remedies

A continuing co-tenancy clause provides that the tenant is entitled to certain remedies if the named co-tenant(s) or a certain percentage of co-tenant(s) cease operations or terminate their leases during the term. Available remedies for the tenant with the benefit of a continuing co-tenancy clause are as follows:

Rent Abatement – Co-tenancy remedies frequently take the form of rent abatement, offering tenants some security that if their promised co-tenant(s) cease operations, their financial burden will be reduced. Such rent abatement may be partial or full but is generally only offered in respect of basic rent. Landlords will, at a minimum, want tenants to pay their share of operating costs and property taxes regardless of whether the co-tenancy condition is met as these costs must be paid by the landlord if not by the tenant.²

As an alternative, landlords may require tenants to pay percentage rent in place of basic rent. This approach reflects and aims to compensate for the actual harm to the tenant and prevents the tenant from benefiting from a breach of a co-tenancy provision that does not negatively impact the tenant's operations or sales. If this remedy is suggested, it will be challenging for a tenant to claim that this remedy is not fair or equitable. If a tenant is not suffering actual financial loss as a result of a co-tenancy condition not being satisfied, it is arguable that the tenant should not be entitled to any remedy.

Right to Suspend Operations – The right to "go dark" is another available remedy to a tenant, permitting the tenant to limit its operations and save costs while a co-tenancy condition is not met. Landlords often prefer to offer this remedy to tenants, as tenants will still be required to make all rental payments under their lease regardless of if they are operating from the premises. However, landlords should be wary of this remedy, as allowing tenants to go dark will negatively affect the shopping centre as a whole and may affect co-tenancy clauses in other leases.³

Right to Terminate – The right to terminate is often the last remedy that can be exercised in the event a co-tenancy condition is not met. If a tenant loses an incentive that motivated it to execute the lease, the tenant may want the option to void the agreement altogether. Such a remedy is typically only available to a tenant after a certain amount of time has passed without the landlord curing such breach, or if the tenant has seen the benefit of other remedies for some defined length of time. It is uncommon for a tenant to have the right

² *Derbawka, supra* note 1 at 6.

³ *Ibid* at 6.

to terminate a lease immediately when a co-tenancy condition is not met. Termination remedies can in fact be beneficial to both tenants and landlords, as they allow tenants to exit unfavourable leases, but they also allow landlords to repossess premises from tenants who are already potentially paying reduced rent pursuant to the exercise of other remedies noted herein. As noted previously, both parties will want to consider whether unamortized tenant and landlord improvement costs, initial rent abatement and leasing commissions should be reimbursable if a party exercises its right to terminate early.

Non-Traditional Remedies

A landlord may also offer non-monetary remedies to a tenant, such as increased signage and marketing promoting the tenant's store within the shopping centre or beyond. For instance, a tenant could be provided with new pylon signage, prominent advertising on the shopping centre website, increased presence on the landlord's social media accounts or other similar rights. Given that a central goal of a co-tenancy provision is to ensure that tenants have sufficient customers, and further given that on-line marketing is becoming significantly more important, it is possible that increased visibility both in person and virtually may provide tenants with the same benefit as a co-tenancy.

Drafting Co-Tenancy Remedies

Tenants and landlords will have conflicting goals when drafting co-tenancy provisions. Establishing clear expectations from the outset reduces the risk of ambiguity as to the parties' intentions should any conflict arise. To ensure that these provisions do not subject landlords to excessive or unnecessary harm, there are numerous issues that landlords should take into consideration at the drafting and negotiating stage.

Definite Timelines – Landlords should take care to ensure that any co-tenancy provisions include clear timelines with respect to, among other things, when a tenant can exercise its right to a remedy, when a landlord must provide notice to a tenant that a co-tenancy condition is not met, any grace periods during which a landlord can cure a breach, and when a tenant must elect to either return to full rent or terminate the lease.⁴ The intent of a co-tenancy provision is to protect a tenant from being trapped in a lease without the incentive that initially drew it to rent the space in the first place.⁵ If that incentive is no longer present and the lack of this incentive cannot be cured by the landlord during a definite period of time (during which a tenant is entitled to temporary remedies), the tenant must either accept the lease without that incentive, under the other terms and conditions of that lease, or it should be required to vacate the space to make room for a new tenant.

Limiting Clauses - Landlords should also ensure that the co-tenancy clauses are as restrictive as possible by stipulating that the tenant can only exercise its remedies in the event that: (i) the tenant is the original tenant under the lease and the lease has not be assigned or sublet, (ii) the tenant is operating in the premises in the manner and for the duration required under the lease (e.g. if required, the tenant is operating during the normal business hours of the shopping centre); (iii) the breach occurs during the initial term of the lease (i.e. the benefit should not automatically extend to renewal or extension terms); and (iv) the tenant is not in material default under the lease. Another suggestion would be to only permit such remedies to be available if the tenant actually suffers a financial loss.⁶ Attempting to determine if a financial loss is directly caused by the departure of an anchor tenant or other co-tenants in the shopping centre may be nearly

⁴ Karsten Lee and Robert Eisenberg, *Keepin' It Tight with Co-Tenancy Clauses*, online: WeirFoulds LLP <<https://www.weirfoulds.com/podcasts/keepin-it-tight-with-co-tenancy-clauses>> [Lee].

⁵ *Derbawka*, *supra* note 1 at 7.

⁶ *Ibid* at 7.

impossible; however, if tenants are still profitable despite an anchor tenant shuttering or other tenants in the shopping centre vacating, the tenants remedies should be limited.

Right to Cure – Landlords should always negotiate a certain period of time to cure the breach of a co-tenancy provision (such cure often being by securing a new tenant to operate in place of a departed anchor tenant) before the tenant is entitled to the benefit of a remedy.⁷ While landlords will want as much time as possible to cure a failure, tenants will want to keep such time period short in order to enjoy any available remedies as soon as possible for as long as possible. If a landlord is able to negotiate a right to cure the breach of a co-tenancy provision before any remedies take effect, the landlord should ensure that it has allowed for enough time to: (i) find a new tenant, (ii) negotiate a new lease, (iii) undertake any necessary landlord's improvement work, and (iv) allow for tenant fixturing. In order to induce a tenant to allow for a long cure period, a landlord may consider committing to certain deadlines for achieving/reaching certain milestones in its process of securing a new tenant, with a failure to meet any of such deadlines immediately triggering the tenant's entitlement to enjoy the benefit of its remedy. By way of an example, a landlord may commit to a deadline for entering into an offer to lease (whether it be conditional or unconditional) with a new tenant, a deadline for entering into a new lease with a new tenant, a deadline for completing its landlord's work and delivering possession of the premises to the new tenant, and a deadline for the new tenant to complete its fixturing and stocking of inventory.

Definition of Anchor Tenant – Another important consideration in drafting co-tenancy provisions is the definition of the anchor tenant or major tenant.⁸ To ensure that the breach of a co-tenancy clause is as easy as possible to cure, landlords should strive to keep the definition of anchor tenant as broad as possible. Commonly, an anchor tenant such as a grocery store will be defined as the exact grocery store tenant currently occupying the space or a replacement grocery store tenant with some defined minimum square footage. There are significant risks to this approach as an issue causing an anchor tenant to suspend operations may be industry-wide, making a departing tenant challenging to replace.⁹ A landlord-friendly definition might define an anchor tenant as one which operates in a “first-class manner”, has a “strong financial record” and/or “high consumer acceptance”. As an example, this would allow landlords to replace a Winners type store with a grocery store (albeit, the premises would require substantial modifications before the replacement tenant could commence operations). Another alternative would be to permit the larger “anchor tenant” to be replaced with a few smaller retailers that meet the classifications above.¹⁰

Alternatively, a landlord might want to abandon the definition of anchor tenant altogether, and instead base the co-tenancy on the percentage of occupancy of the shopping centre, rather than the occupancy or operation of a particular tenant. If a landlord does take this approach, it should take care to contemplate any potential redevelopment or demolition work that may occur at the shopping centre, which work could suddenly cause the total square footage of the shopping centre to instantly plunge and trigger a co-tenancy failure.^{11 12}

⁷ *Ibid* at 7.

⁸ *Lee, supra* note 4.

⁹ *Derbawka, supra* note 1 at 5.

¹⁰ *Ibid* at 5.

¹¹ *Park Royal Shopping Centre Holdings Ltd v Gap (Canada) Inc.*, 2017 BCSC 1257.

¹² Stacy J. Handley, *Retail Apocalypse: The Demise of Brick-and-Mortar Retail and its Impact on Co-Tenancy Provisions in Shopping Centre Leases*, presented at Pacific Business & Law Institute Law Conference, UBC Robson Square, Vancouver, British Columbia, March 6, 2020.

Developments in Co-Tenancy Remedies

Covid-19 Pandemic and Force Majeure Clauses – The Covid-19 pandemic imposed a wide range of government restrictions on business operations that forced many businesses to close for indeterminable lengths of time.¹³ These closures forced landlords into a position of co-tenancy failure, with no foreseeable cure or alternative tenant in sight. With the information from this recent experience in mind, landlords may wish to except out closures due to government restrictions in their co-tenancy provisions.

These government restrictions have an interesting impact on leases with co-tenancy provisions, as the restrictions on the operation of an anchor tenant's business are likely to impact an affected co-tenant's business as well. This scenario demonstrates the importance of a curative clause that requires a tenant to be operating itself in order to see the benefit of a co-tenancy remedy. Future drafters of co-tenancy provisions would be prudent to contemplate pandemic-related matters and force majeure clauses and their impact on co-tenancies.

Mixed-Use Developments – In the mixed-use development context, the presence of residents in a residential strata or rental tower frequently provide a significant percentage of sales to the commercial tenants within the development. For example, the grocery store on the ground floor of a residential tower may depend on the residents of the tower above to stay in business. Such commercial tenants may wish to base their co-tenancy provisions on the occupancy of a residential strata or rental tower. For instance, a tenant may negotiate its opening date (or rent commencement date) on the date that a certain percentage of residential units have been conveyed to purchasers. If the developer is retaining its interest in a residential rental tower above, a tenant's remedies may be triggered in the event that occupancy falls below a certain percentage. Landlords should remain open to these kinds of negotiations as developments push further outside of urban centres and these tenants need greater incentives to rent these spaces.

Final Thoughts

Although the future is impossible to predict, it seems more likely than not that consumer interest in online retail shopping will only increase over time, and landlords will face ever-greater challenges in persuading commercial tenants to lease space in traditional shopping centres. Accordingly, offering co-tenancy provisions as an incentive in a lease may become a norm that landlords must be prepared to accept. Given the potential risks a landlord may face when a co-tenancy provision is drafted without the landlord's interests in mind, it would serve landlords well to exercise caution with respect to these provisions.

¹³ Lisa A. Borsook, *The Implementation of a Co-Tenancy Right – Enforceability and Duties of Good Faith and Reasonableness*, [date unknown/citation information unknown].