

THE (ALMOST) PERFECT CO-TENANCY CLAUSE

Cory Sherman
Sherman Brown

John Shrives
Sherman Brown

When negotiating a lease, a co-tenancy provision can give a tenant comfort in relation to the long-term viability of the shopping centre. Tenants want to have some certainty that that centre is going to continue to attract customers and that their new location will have good foot traffic and visibility to the public. A co-tenancy clause requires the landlord to guarantee a specific merchandising mix of key or named tenants and/or satisfy a minimum occupancy threshold. Co-tenancy provisions are based on the idea that the shopping centre's ability to attract customers is linked to either specific large retailers or a certain proportion of tenants in the shopping centre being open for business.

The particular details of a co-tenancy provision will depend on the negotiating power of the parties, and only select tenants are able to obtain co-tenancy provisions in their leases. Co-tenancy provisions require the landlord to assume significant risk and therefore the tenant must have a strong negotiating position for the landlord to grant this type of right. In most cases, only large national tenants with significant leverage will be able to successfully negotiate a co-tenancy provision into their leases.

While there are many different approaches to structuring a co-tenancy provision, there are three key components that are essential.

First, the wording should clearly identify what type of co-tenancy provision is contemplated. There are two broad categories of co-tenancy provisions: opening co-tenancy provisions and operating co-tenancy provisions. An opening co-tenancy provision sets out certain occupancy conditions which must be satisfied prior to the tenant opening for business in the premises, whereas an operating co-tenancy provision sets out occupancy conditions which must be satisfied throughout the term of the lease.

Second, a co-tenancy provision must identify the operating requirements to be satisfied. The necessary operating requirements can be structured in different ways. The provision might require:

- (i) a specific named tenant(s) or key store(s) to be open and operating;
- (ii) tenant(s) occupying "anchor premises" or premises with a rentable area exceeding a particular threshold to be open and operating;
- (iii) an occupancy threshold to be satisfied based on either a number of tenants or percentage of the rentable area of the shopping centre; or
- (iv) some combination of the above.

Third, what remedies are available to the tenant if the co-tenancy provision is breached. In the case of an opening co-tenancy provision, the tenant's remedy is typically to delay its own opening or to open at a reduced rent. When it comes to operating co-tenancy provisions, the most common remedy is a rent abatement, which could be achieved in many ways. Sometimes the lease will set out a rent rate that applies following a co-tenancy breach. Other times, the rent currently being paid will be reduced by a given percentage. Another common solution is to have the tenant pay rent based on a percentage of gross revenue during the period of the co-tenancy breach. In addition to rent abatements, the tenant might also have the right to go dark for the duration of the co-tenancy breach and/or the right to terminate the lease if the co-tenancy breach lasts for a specified length of time.

Beyond these three basic components, lawyers drafting co-tenancy provisions should also consider the following points:

A Landlord's Perspective: Required Conditions

Landlords do not want to grant co-tenancy provisions. The remedies available to the tenant in case of breach are significant. Further, co-tenancy provisions require the landlord to make guarantees over something it cannot directly control. The bankruptcy of a large retailer with anchor tenant premises in several shopping centres could have major consequences for a landlord. The retail industry is constantly evolving and landlords want to have the flexibility to adapt their shopping centres to respond to new market trends.

Landlords will therefore seek to impose conditions on the co-tenancy provision. For example, landlords often insert wording that the co-tenancy right is conditional upon the tenant not being in default, the tenant being open and operating as required under the lease, and that the co-tenancy right is personal to the tenant only and cannot be assigned. It is understandable that the co-tenancy provision not be transferable given that the landlord has granted this right to attract a particular tenant.

Must the Tenant Demonstrate a Loss Following a Co-Tenancy Breach?

Co-tenancy provisions are meant to guarantee the tenant that the shopping centre will continue to attract customers. The assumption is that if the operating requirements are not met, that traffic to the shopping centre will decrease, and that the tenant will be negatively impacted. The remedy in the co-tenancy provision is not meant to penalize the landlord, but instead is meant to represent an estimate of the tenant's damages suffered as a result of the breach.

But what if the tenant's business is thriving despite a co-tenancy failure? Is the tenant entitled to the benefit of a co-tenancy remedy, especially a rent abatement, if its sales continue at the same level or even improve following a co-tenancy failure? The case of *Old Navy (Canada) Inc. v The Eglinton Town Centre Inc.* provides a cautionary tale for tenants in Ontario exercising co-tenancy remedies in the absence of any loss. In that case, Old Navy's lease contained a co-tenancy provision that named four "key stores", one of which was Danier Leather.¹ All four key stores were required to be open, otherwise Old Navy did not have to open or operate and need only pay 50% of Minimum Rent for the first three months of co-tenancy failure and 25% of Minimum Rent thereafter (the "Alternative Rent").² In February 2016, Danier Leather filed for bankruptcy which created a co-tenancy failure.³ The landlord proposed other retailers who could replace Danier Leather as a "key store", but Old Navy did not respond, later taking the position that these substitute retailers were not qualified replacements.⁴

In interpreting the co-tenancy provision the court considered the impact of the co-tenancy breach on Old Navy. Despite Danier Leather's bankruptcy, the shopping centre was over 90% leased and there was no decrease in shopper traffic. Old Navy suffered no losses, yet by paying the Alternative Rent, Old Navy was barely covering half of its share of CAM and the landlord was receiving no minimum rent.⁵ The fact that Old Navy had not suffered damages was a relevant factor in the court's interpretation of the clause and the court's ultimate decision that Old Navy's interpretation was commercially unreasonable.

¹ 2019 ONSC 3470 at para 23.

² *Ibid* at para 26.

³ *Ibid* at para 35.

⁴ *Ibid* at paras 42-45, 52-60.

⁵ *Ibid* at paras 166, 172, 212.

So could a landlord argue that a co-tenancy remedy is an unenforceable penalty? That remains an open question in Ontario. The court in *Old Navy* considered the issue but did not rule on that point. With this in mind parties negotiating a lease might consider making the exercise of co-tenancy remedies conditional on the tenant suffering a loss in gross revenue following the co-tenancy breach. At the time of lease negotiation, it is impossible for the parties to estimate exactly what impact the co-tenancy breach will have on the tenant's business. However, if the remedy is conditional upon the tenant actually demonstrating that it has suffered a loss, this will go a long way towards showing that the rent abatement is a reasonable estimate of damages and not an unenforceable penalty.

Replacement or Substitute Stores

A well-drafted co-tenancy provision requires flexibility in terms of the operating requirements. As discussed earlier, the retail industry is constantly changing and retailers come and go. While the landlord is assuming certain risks by agreeing to a co-tenancy provision, a landlord cannot guarantee that a particular retailer will continue to operate in the shopping centre for the duration of the tenant's lease. The more stores that are named in a co-tenancy provision, the greater the likelihood that one of these stores will close during the term of the tenant's lease. If a specific store is named in the co-tenancy provision, the landlord must have the ability to propose a substitute or replacement tenant in the event that a named store ceases operations. Otherwise, the landlord has no opportunity to cure the default and the co-tenancy provision runs the risk of being seen as commercially unreasonable.

Tenants should insist that the replacement store be comparable in status and size to the store that it is replacing. This can be accomplished by setting out the parameters of what constitutes a replacement store. Objective criteria for replacement stores can be useful to avoid any ambiguity in the future. For example, requiring that the replacement store operate in premises of a particular size (often 25,000 square feet or more), requiring that the replacement store be a national or regional retailer operating a certain number of locations in Ontario or Canada, or providing a list of approved substitute stores can be useful approaches to provide certainty to the parties. Many tenants want "pop up shops" and seasonal or temporary stores to be excluded from the definition of replacement store and so another objective criterion could be that the length of the replacement store's lease must be of a certain duration. If the co-tenancy provision is based on the "anchor premises" being open and operating, the parties should determine whether the anchor premises can be divided and leased to several smaller retailers. Though more subjective, criteria relating to the use, quality and/or price point of the replacement store's merchandise can also provide useful guidance.

The criteria for replacement stores should also have some flexibility. In recognition of new retail trends and up and coming brands, the parties should consider adding wording allowing the landlord to propose replacement stores to the tenant for tenant's approval. Again, it is recommended that the parties include criteria that the tenant will consider to determine whether or not it will grant its approval, such as the number of locations operated by the replacement store, the quality and fashion level of the replacement store, how much space the replacement store will be occupying in the shopping centre, etc.

Adding a Sunset Clause

All good things must come to an end. While a tenant might love the idea of paying abated rent in perpetuity, there comes a time when such a scenario becomes commercially unreasonable. In determining that Old Navy's interpretation of its co-tenancy provision was commercially unreasonable in the case discussed

above, the court noted that Old Navy could potentially go on paying the Alternative Rent indefinitely as a factor.⁶

A sunset clause limits the time period in which the tenant can benefit from a co-tenancy remedy. Once the time period has expired, the parties must then decide whether to revert to the status quo or terminate the lease. The exact parameters of the sunset clause will vary case to case. In some cases, it might be that the tenant is forced to choose between resuming the payment of full rent (and/or resuming operations in the premises if the tenant is exercising a go dark remedy) and terminating the lease. Alternatively, it might be the landlord who has the option of either terminating the lease or continuing to accept reduced rent from the tenant. Regardless of who has the ability to terminate, the parties should turn their minds to the timeframe in which the termination right can be exercised: is it a one-time right or is it an ongoing right that can be exercised at any time? There are a wide variety of options for drafting the sunset clause, but what is key is that there is a mechanism limiting the tenant's ability to seek the benefit of co-tenancy remedies indefinitely.

Tenants should have the right to rescind the landlord's termination. If the landlord cannot or will not cure the co-tenancy breach and chooses to terminate the lease, the tenant must have the option to resume paying the rent set out in the lease, and thus invalidating the landlord's termination. Given the investment the tenant has made in the premises, it is fair that the tenant have the option to decide whether its operations from the premises are viable, notwithstanding the co-tenancy breach.

If the co-tenancy provision includes a termination right tenants should push for compensation following termination. Most tenants make significant investments when leasing premises and if the tenant has not received the full benefit of their lease because of a co-tenancy breach, the tenant should seek to be compensated for its unamortized leasehold improvements and related design or consultant fees.

Conclusion

Co-tenancy provisions convey substantial benefits to tenants by allocating certain risks to the landlord. However, the provision must be drafted clearly and must avoid certain pitfalls which can render the co-tenancy remedies ambiguous, or worse, unenforceable. By balancing objective criteria and clear timelines with the need for flexibility to adapt to new and changing circumstances, lawyers can ensure that the co-tenancy provisions they draft give effect to the intentions of the parties and are rooted in the commercial reality of the transaction.

Cory Sherman
Sherman Brown

John Shrives
Sherman Brown



⁶ *Ibid* at paras 169-173.

APPENDIX – Sample Operating Co-Tenancy Provision

A. OPERATING REQUIREMENT:

Provided Tenant is [**NAME OF TENANT**] or a Permitted Transferee pursuant to Section [**X**] of this Lease and is itself conducting business from the whole of the Premises in accordance with the terms of this Lease and Tenant is not in default under this Lease beyond any applicable notice and cure period, then if at any time during the Term of this Lease:

- (i) two (2) Key Stores (those retailers operating as [**NAME OF KEY STORES**]); and
- (ii) CRU stores comprising twenty-five percent (25%) of the GLA of the Project or more (collectively, the “**Operating Requirement**”),

fail to be open for business for any reason (with the exception of Force Majeure, or temporary closure for renovations), then the Landlord will be deemed to have not met the Operating Requirement.

B. TENANT REMEDIES:

If Landlord has not satisfied the Operating Requirement for a period of one hundred and twenty (120) consecutive days (the “**Period**”), Tenant may, during the period from and including the day following the Period until the day the Operating Requirement has been met:

- (i) close for business in the Premises (“**Tenant Closure Remedy**”); or
- (ii) pay in lieu of Minimum Rent, Percentage Rent and Additional Rent under this Lease, an amount equal to fifty percent (50%) of the total amount of Minimum Rent and Additional Rent for each month thereafter (the “**Alternate Rent Remedy**”), and otherwise payable in accordance with the terms of this Lease. Notwithstanding the foregoing, Tenant shall continue to pay all amounts for utilities.

Tenant may not exercise both remedies contained herein simultaneously but may exercise such remedies alternately from time to time until the Operating Requirement has been met. All other covenants and obligations of Tenant shall continue in full force and effect including, without limitation, the covenant to pay all Rent under this Lease.

C. SATISFACTION OF THE OPERATING REQUIREMENT:

Upon the date that the Operating Requirement has once again been met, Tenant shall in the case where Tenant elected the Tenant Closure Remedy, reopen the Premises for business and, in the case where Tenant elected the Alternate Rent Remedy, cease the payment of the Alternate Rent Remedy, and forthwith resume (where same had been suspended) the payment of Rent set out in this Lease.

D. SUNSET CLAUSE:

If the Operating Requirement is not met during the twelve (12) month period immediately following the Period, both Landlord and Tenant shall have the option to terminate this Lease upon not less than

six (6) months' written notice to the other party, such right to be exercised within sixty (60) days following the expiry of such twelve (12) month period set out above.

If Landlord elects to terminate this Lease, Tenant may provide written notice to Landlord that it elects to remain in the Premises and resume the payment of the Rent payable by the Tenant in accordance with the terms of this Lease as if the Operating Requirement was being met. Tenant shall deliver such notice to Landlord within fifteen (15) days of receipt of Landlord's termination notice and the Lease will be reinstated effective as at the end of the twelve (12) month period immediately following the Period. If Tenant delivers a reinstatement notice as set out herein, Landlord's termination notice will be deemed null and void and of no force and effect.

In the event this Lease is terminated pursuant to this Section, Landlord and Tenant shall be released and discharged from any obligations or liabilities which arise from and after the termination date of this Lease, save and except for those obligations which arose or are attributable to the period prior to such termination.

E. REPLACEMENT STORES:

Landlord can replace a Key Store (the "**Replacement Store**"), without Tenant's consent, if such Replacement Store is a retailer occupying at least ninety percent (90%) of the space formerly occupied by the vacating Key Store, provided such Replacement Store is a national retailer with at least fifteen (15) stores operating under the same trade name.

If the Replacement Store does not satisfy the criteria above, Landlord shall submit the name of the Replacement Store to Tenant for its prior written approval. In considering whether to grant its approval, Tenant may consider: (i) the number of other locations operated by the Replacement Store under the same trade name in Canada; (ii) whether the Replacement Store's use is substantially the same as the vacating Key Store; and (iii) the quality and retail price of the Replacement Store's merchandise in relation to the quality and retail price of the vacating Key Store's merchandise.

