

## CO-TENANCY ISSUES IN A CHANGING RETAIL MARKET

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### What is a Co-Tenancy?

A co-tenancy clause is a provision in a lease requiring the existence of minimum occupancy conditions, the details of which will ultimately depend on the negotiating power of the parties and the willingness for each party to allocate a certain level of risk. A co-tenancy clause provides the tenant a certain level of protection by requiring the landlord to guarantee a specific merchandising mix tenants and/or a minimum occupancy threshold tied to a percentage of square footage or number of tenants being open and operating at the shopping centre. Given the rise of retail bankruptcies and other disruptors in the market, landlords are now more than ever forced to make the allocation of risk in terms of a co-tenancy clause an even more important consideration as it is not able to control the actions of other tenants and market conditions.

There are two main types of co-tenancies, each of which serve a different purpose to the tenant and involve a different allocation of risk to a landlord.

- 1. Opening Co-Tenancy** - requires that the landlord achieve a particular occupancy threshold in order for the tenant to open its business, failing which, the tenant will be entitled to specific remedies. This type of co-tenancy is commonly seen in the development or the redevelopment of an existing centre. The opening co-tenancy threshold could contain one or a combination of conditions including specific named tenants be open and operating or a certain percentage of tenants or square footage be open and operating on the same day that the tenant is required to open for business or the grand opening date for all tenants.
- 2. Ongoing Co-Tenancy** - This type of co-tenancy provides a tenant with certain remedies in the event a certain percentage/number of tenants or certain tenants are not open and operating during the term of the lease.

The key difference between the ongoing co-tenancy and opening co-tenancy is that once the requirements have been met in the opening co-tenancy, the co-tenancy becomes null and void. Whereas in an ongoing co-tenancy, the landlord's obligations need to be maintained throughout the term of the lease. Regardless of type, each co-tenancy provides for operating requirements and remedies.

### 10 Things to Remember When Drafting a Co-Tenancy

- 1. Clear Operating Requirements** – Generally, there are three types of operating requirements: (a) a minimum number of major tenants or anchor tenants be open and operating; (b) a minimum occupancy threshold be maintained; and (c) specific named/key tenants be open and operating. When combining multiple types of operating requirements, careful drafting is necessary to ensure the intent of the parties and the nuances are properly captured. One unintended word can change the interpretation of the entire clause.
- 2. Replacement Tenant to adapt to an Evolving Retail Market** – When a co-tenancy clause has named tenants, it is important to have the ability to replace any of the named tenants with another suitable and qualified tenant. At the outset of a negotiation, both sides must recognize the importance of flexibility in the evolving retail market in which they are operating. A strong lease is one that remains applicable in a continuously evolving market.
- 3. Grace Period** - One way to create some flexibility and mitigate this risk is for a landlord to include a grace period prior to allowing the tenant to go dark. By including a grace period, the landlord is afforded some time to

mitigate the situation and try to re-lease the space and fulfill the co-tenancy requirement before the tenant may exercise its remedies.

**4. Sunset Clause Provision** - A sunset clause will limit the period of time during which the tenant can pay reduced rent while the co-tenancy remains in failure. In particular, it allows the landlord to “stop the bleeding” at a particular point in time and force the tenant to make a decision to either revert back to paying full contracted rent or terminate the lease. From a landlord’s perspective, this can be helpful as it allows a landlord a degree of certainty as to when a tenant’s remedy will expire and provides a landlord the ability to forecast its financial exposure in the event of a triggered co-tenancy failure.

**5. Alternative Rent Remedy** - A common remedy in the event of a co-tenancy failure, is the right for a tenant to pay reduced rent during the co-tenancy failure. Typically, a tenant will have the right to pay a percentage of its gross sales in lieu of full rent as contracted in its lease. A landlord must consider whether the tenant will be responsible for paying any additional rent, including operating costs, taxes, utilities and other charges otherwise payable by the tenant.

**6. Sales Test** - The concept that a tenant should be entitled to a remedy is premised on the idea that a tenant has or will be impacted financially as a result of the operating requirements not being satisfied. One way to establish that there has been a financial impact on a tenant is by including a “sales test” as a condition of a tenant being entitled to its remedies. A “sales test” will typically require a financial analysis of a tenant’s sales before and after the failure of the operating requirements has been established. The tenant will need to establish that it has incurred a reduction in sales, thereby showing damages entitling the tenant to pay reduced rent.

**7. Clearly Defined Co-Tenancy Failure** – What trigger’s a tenant’s co-tenancy remedies must be clearly stated in the lease. Further, any exceptions that would not permit a tenant to exercise its co-tenancy remedies should be clearly set-out. For example, where a tenant ceases to operate due to a fire, destruction, or development of the shopping centre.

**8. Return of Tenant Inducements on Termination** – If a tenant is given the option to terminate the lease, the landlord should ensure that if the tenant exercises that right, it is required to repay the cost of any inducements paid by the landlord. For example, if the tenant received a tenant allowance upon the commencement of the lease, the landlord may want to contract for the return of the unamortized portion of the tenant allowance. On the other hand, tenants should ensure that if the landlord exercises its right to terminate, the tenant is not required to repay the unamortized portion of the tenant allowance.

**9. Notice of Co-Tenancy Failure** – Most co-tenancy clauses require the tenant to notify the landlord of a co-tenancy failure. If a tenant notices that other tenants, especially named tenants, have ceased operation, it should contact the landlord to confirm whether there has been a co-tenancy failure.

The landlord should be sure that a co-tenancy clause does not require it to provide notice to the tenant regarding the co-tenancy and that they are not required to provide a breakdown of each tenant’s leasable area or other information to tenants. This can create a cumbersome burden on the landlord.

**10. Personal Right** – It is best practice to ensure that the clause makes the right to the co-tenancies personal to the tenant. The landlord has completed its risk assessment in granting the co-tenancy clause based on the original tenant in the lease. If a new tenant comes in, there is a new risk assessment that needs to be done.

