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Workshop #14

"CO-TENANCY – IS IT THE CARROT, OR THE STICK (OF DYNAMITE)…OR BOTH?"

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Co-tenancy provisions, when included in leases, are some of the most important and heavily negotiated sections of any shopping center lease. On the one hand, landlords have limited control over when other tenants open or whether or not they continue to operate, despite the provisions in their leases. Therefore, it is risky for a landlord to grant tenants co-tenancy rights, and something landlords always want to avoid. On the other hand, many retail tenants want to do their best to ensure that, when they commit to a long term lease in a shopping center, the shopping center will contain the high quality tenants or retail activity promised by the landlord and, if not, then at least a reduced rental. The best way for the tenant to accomplish this is through a co-tenancy provision.

These materials discuss significant issues in negotiating co-tenancy provisions of retail leases.

1. What is a Co-tenancy?

A co-tenancy provision permits a tenant to exercise remedies if certain conditions are not met with respect to the shopping center in which it is located. As discussed below, co-tenancy provisions can be tied to the existence of certain "key" tenants or to an occupancy threshold based on a percentage of total tenants or to a square footage number. Tenants want co-tenancy provisions, which may relieve them from being obligated to open, pay full rent or operate in a shopping center that is not fully occupied, to provide for a remedy in the event that the synergy of the applicable shopping center is affected. Landlords dislike co-tenancy provisions because (i) they cannot control the actions of other tenants or occupants in the shopping center, (ii) they feel that a certain amount of vacancy is unavoidable, and (iii) their rent stream from the shopping center can be severely impacted.

2. Leverage.

Whether or not a tenant is successful in obtaining a co-tenancy provision is largely dependent on the negotiating leverage that the tenant possesses. National and large regional credit tenants are generally highly sought after by landlords because of their name recognition, ability to pay higher rents and staying power, and "hot" tenants are desirable because they have drawing power and can increase the cachet and prestige of a shopping center. Such tenants usually are in a better position to obtain co-tenancy protection than smaller regional, lesser credit and shop ("mom and pop") tenants. However, in certain economic climates, some of such smaller tenants also request, and in some cases get, co-tenancy protection. The reasoning is typically that, with a struggling economy, a "mom and pop" tenant will need to be sure that the major and mini-major tenants who generate a fair amount of foot traffic will be open and operating. Without such foot traffic, and with consumers being more and more careful with their disposable income, the "mom and pop" tenant could really suffer.

3. Opening Co-tenancy.

Co-tenancy provisions generally fall into two categories. The first is an opening co-tenancy, which provides that a tenant need not open its store at full rent until and unless certain other stores, or a certain amount of stores, in the shopping center are open. An opening co-tenancy is usually found in the context of a shopping center in development, which may still be in the entitlement, lease-up or construction phase, but may also be found in an existing shopping center that is being redeveloped. Likewise, in the case of a shopping center in an outlying growing area where demographic projections are still somewhat conjecture, a tenant will want assurances that the shopping center will be built and occupied before it commits itself to that shopping center.

4. Operating Co-tenancy.

The second general category of co-tenancy is an operating co-tenancy, which provides that once a tenant has opened and is operating, it will be obligated to stay open at full rent subject to certain other stores, or a certain amount of stores, also operating. An operating co-tenancy is not limited to any particular type of shopping center, as no matter where the shopping center is located or how old or new it is, a tenant will not want to be required to stay open in a shopping center where other stores are closing.

5. Key Tenants.

Co-tenancies are often geared to certain "key" tenants, so-called because they are viewed by the tenant seeking co-tenancy protection as "key" to the success of the shopping center and/or the particular tenant. For example, a tenant generally will not want to be obligated to open or keep operating its store at full rent unless the anchor store in the shopping center, usually a department store in a regional mall or a grocery store in a neighborhood shopping center, is also open and operating. Where there is no true anchor store – *i.e.*, no store is dominantly larger than the other sizable stores (such as in a power shopping center) – a tenant may not want to be open or operate at full rent unless a certain number of mini-major (roughly 15,000 to 30,000 square feet) stores are also open and operating. And sometimes, a tenant may require that a certain percentage of the shopping center be open or operating before that tenant has to open or keep operating at full rent. Sometimes (depending on the size of the project), a tenant with significant negotiating power will require that a combination of two or even all three of the above be satisfied before it must open or keep open its store at full rent – *e.g.*, a tenant may require that one of two anchor stores, four of seven mini-major stores, and 75% of the shop spaces, or at least 100,000 square feet of space in the shopping center, be open before that tenant is required to open its store and begin operating, or, if already operating, to keep operating at full rent.

6. Replacement Tenants.

Tenants seeking co-tenancy protection typically specify the name of the anchor and/or mini-major store(s) that must be open and operating, as landlords usually try to obtain commitments from anchors and mini-majors before committing to develop a shopping center, and the tenant is relying on the existence of that (or those) particular tenant(s). While a landlord may agree to a co-tenancy provision, it will want to avoid being locked into the specifically listed stores, because landlords are only too aware of the fickleness of the retail sector – today's "hot" retailer might be in bankruptcy court in a few years. Therefore, landlords will typically require that a co-tenancy provision is satisfied if a "replacement" tenant is open and operating in lieu of a key tenant that is no longer operating. This is usually acceptable to tenants if the replacement tenant is comparable to the named or departing tenant. For example, a landlord may require that a replacement tenant which occupies most of the vacated space, has a similar (*i.e.*, soft goods or electronics) business, and is comparable in creditworthiness to the departing tenant be deemed to satisfy a co-tenancy provision.

7. Conditions.

Before a tenant can invoke a remedy under a co-tenancy provision, a landlord will want the tenant to satisfy certain conditions. Foremost is that the tenant is not then in default under the lease, but such conditions may also include that the tenant is itself operating at the time of a violation of the co-tenancy provision, and that the right to invoke the remedy is personal to the original tenant that signed the lease. A landlord may also require that the tenant show a drop in sales during the co-tenancy violation period as compared to the period prior to the violation. Finally, a landlord will want to make sure that, if the tenant invokes a co-tenancy provision, the remedy elected by the tenant for such co-tenancy violation is the tenant's sole remedy for such violation. A landlord does not want to be in a situation where the tenant obtains the benefit of a co-tenancy violation remedy, such as rent abatement or termination, only to have the tenant sue for other damages.

8. Cure.

A landlord will also want to have the right to cure a co-tenancy violation before the tenant can invoke any remedies, as the violation might occur with little or no warning, such as a bankruptcy filing. The cure right almost always involves the right to try to obtain replacement tenants for the key tenants, or, in the case of an occupancy threshold, to try to fill the vacant space. Therefore, most landlords will agree to a co-tenancy right only if the violation continues for a significant period of time, with the amount of time depending on the types of remedy that the tenant may elect.

9. Remedies.

A tenant's remedies for a co-tenancy violation commonly fall into three categories. The first such remedy is rent abatement, where if a co-tenancy violation is not cured within the stated time period, the tenant has the right to pay a lesser rent for so long as the co-tenancy violation exists. The lesser rent is typically based on either a percentage of the fixed annual rent (usually 50%) or percentage rent only during the violation period. The second remedy for a co-tenancy violation is termination of the lease, but as this is an extreme remedy, landlords are loathe to grant it unless the co-tenancy violation continues for an extended period of time – at least six months, often a year, and even longer if the space is particularly large (such as a space occupied by Target, Home Depot or Wal-Mart). An operating co-tenancy provision will usually allow for rent abatement and termination (because rent abatement is not as drastic, a landlord will often permit a tenant to invoke that remedy sooner than the termination remedy, often as soon as the violation occurs) The third remedy for a co-tenancy violation usually only arises if there is an opening co-tenancy violation, and allows the tenant to delay the opening and/or rent commencement date (although most tenants will also want to have the right to open but with rent abatement as set forth above).

10. Return to Full Rent; Recapture.

If a tenant elects rent abatement, the landlord will not want the tenant to be able to take advantage of the substitute rent provision for the remainder of the lease term. In such an instance, a landlord will typically require that if the co-tenancy violation is not cured within a certain period of time (typically one year) and the tenant has not terminated the lease within that time, then the tenant will have to return to paying full rent. The obligation to return to paying full rent is based on the theory that if the tenant is remaining in the shopping center despite the co-tenancy violation it must believe that its store is doing well enough to warrant continuing at full rent. If the tenant does not want to return to full rent, then the landlord will usually insist on the right to recapture the premises or the tenant exercising a termination right.

11. Reimbursement.

If either party terminates the lease due to a co-tenancy violation, the tenant will want to be reimbursed for its unamortized leasehold improvements (typically amortized on a straight-line basis over the initial term), since the termination was not due to an event within the tenant's control. However, reimbursement should only apply during the initial term of the lease, as that is the length of time on which the tenant based its original decision to enter into the lease. Whether or not the landlord agrees to reimburse these costs is often a significant issue of negotiation.

Replacement Tenant Issues

Many large or credit-worthy retailers require a co-tenancy provision in their leases. For the most part, co-tenancy provisions provide retailers with certain remedies (such as, but not limited to, reduced rent and termination rights) if certain named retailers fail to open or remain open at a shopping center. Co-tenancy provisions will also usually reference a percentage of the gross leasable area in the shopping center that must be open and operating, failing which, the retailer will have the remedies set forth above.

When a co-tenancy provision identifies a particular retailer, it is critical that landlords give themselves the right to replace named co-tenants with other similar (or dissimilar, as stated below) tenants so as not to give the tenant with the co-tenancy provision the right to pay reduced rent or terminate its lease if the co-tenant ceases operations. For example, if a named co-tenant goes dark or terminates its lease, the landlord should have the right for a period of six months (or longer, if the reason for the go dark or termination relates to a casualty) to replace such named co-tenant with (a) a reasonably comparable retailer in all or substantially all of such named co-tenant's space, (b) another comparable retailer of other space in the shopping center, (c) two or more retailers that together occupy space reasonably comparable to the named co-tenant, or (d) a retailer operating for a completely different use than the named co-tenant so long as such replacement retailer is a reasonably comparable draw to the shopping center as the named co-tenant.

In today's changing retail landscape, especially in connection with anchor retailers at regional malls, it is important to consider that a department store may not be replaceable with another department store due to the ever shrinking number of department stores. In addition, even if the landlord can find a replacement department store in a regional mall context, it may make more sense to replace the department store with a completely re-tenanted building. For instance, a department store that has not kept pace with the current retail climate may be better replaced with a theatre and numerous restaurants, a high-end bowling alley and restaurants, or a multi-family use with retail on the ground floor. The concern of the retailer possessing the co-tenancy clause in its lease may or should be that the use generates a comparable number of trips to the regional mall by a demographic that is similar to or better than that generated by the co-tenant being replaced.

The following is a sample replacement co-tenancy provision for use in a regional mall:

> For purposes of the Initial Occupancy Conditions, the term 'equivalent replacement' shall mean one (1) tenant or occupant or an aggregate of two (2) tenants or occupants, each of whom operates at least ten (10) other stores as of the date such tenant or occupant will occupy the applicable premises; provided, if any such tenant or occupant does not operate at least ten (10) other stores, then such tenant or occupant shall be subject to Tenant's prior written approval, which approval shall not be unreasonably withheld, conditioned or delayed. For purposes of the Subsequent Low Occupancy Condition, the term "equivalent replacement" shall mean one (1) tenant or occupant or an aggregate of multiple tenants or occupants, each of whom singly or in combination with the other, will draw patrons or customers to the Shopping Center in comparable levels as other comparable first-class shopping centers in the _____, California area. For avoidance of doubt, multiple tenants satisfying the requirement set forth in the preceding sentence that, in the aggregate, occupy at least seventy percent (70%) of the applicable premises of one of the retailers listed under clause (a) above shall be deemed collectively as an "equivalent replacement" for purposes of this paragraph.

As indicated above, it is imperative that landlords, when negotiating co-tenancy provisions, give themselves the flexibility to replace named co-tenants with a variety of different tenants and uses to avoid the remedies available to the retailer whose lease contains the co-tenancy provision.

When a Co-tenancy is Violated

When negotiating shopping center leases, landlords sometimes grant to tenants certain "co-tenancy" rights, often as an added incentive to lure certain tenants to a project. Generally stated, a co-tenancy provision provides a tenant with certain remedies if one or more select tenants, or a certain percentage of tenants, leave(s) a shopping center. Such remedies often include the payment of reduced rent for a certain period, the payment of a percentage of sales in lieu of base rent, or lease termination.

In the current economy, with shopping center vacancies on the rise, some landlords are in the position of having to deal with co-tenancy violation claims. Such co-tenancy violations may result from the departure of one or more "anchor" tenants, or the cessation of operation by tenants formerly occupying a significant square footage of the shopping center (*i.e.,* a shopping center where 40% of the gross leasable floor area is now unoccupied due to tenants shuttering their businesses).

Any landlord that receives a notice from a tenant claiming a co-tenancy violation should address the situation immediately and consider the following:

Confirm the alleged violation.

Not surprisingly, the landlord should review the applicable lease and other relevant documentation to determine whether the current situation at the shopping center indeed results in a co-tenancy violation. In doing so, the landlord will want to consider several issues, including the following:

- In the event the alleged co-tenancy violation is not site or tenant specific (*e.g.*, if the lease requires that at least one national or regional soft goods retailer is operating from the shopping center at all times, as opposed to requiring that Kohl's (or a tenant in a specific location (usually in close proximity to the co-tenancy holding tenant)) is continuously operating from the shopping center), the landlord should determine whether another tenant at the shopping center who *is* operating can satisfy the requirement. The landlord may also be able to take advantage of ambiguity in the co-tenancy provision to argue that the requirements of the lease continue to be satisfied, despite vacancies by one or more tenants.

- If the alleged co-tenancy violation is based on the total square footage of the shopping center, the landlord should confirm that the numbers used by the tenant are accurate. For example, if the lease provides that a co-tenancy violation occurs if, at any time, less than 60% of the square footage of the shopping center is occupied, and the tenant claims such a violation, the landlord should calculate carefully the unoccupied square footage to determine whether the tenant's claim is valid. The landlord likely has more accurate information regarding the square footages of all of the spaces at the shopping center and may be able to argue that the tenant's calculations are incorrect.

Review the conditions attached to a claimed violation.

The landlord should also determine whether the tenant has satisfied any conditions set forth in the lease which need to be met in order for a co-tenancy violation to exist. For example, the lease may provide that a tenant may claim a co-tenancy violation only if the tenant is not in default and is operating from its premises at the time the claim is made. Or, there may be language that states that the right to invoke a remedy for a co-tenancy violation is personal to the original tenant that signed the lease, in which event the landlord should confirm that the tenant making the claim is not in possession of the premises following an assignment or sublease. In addition, the co-tenancy provision may require that a tenant show a drop in sales during the co-tenancy violation period as compared to the period prior to the violation. In such an instance, the landlord should require the appropriate documentation (delivered in satisfaction of the requirements of the lease), and should scrutinize the same carefully to determine whether the applicable thresholds are met.

Review the landlord's cure rights.

If drafted favorably to the landlord, the co-tenancy provision might provide landlord with a lengthy cure period in which to rectify the co-tenancy violation. For instance, the landlord may have up to a year (or more) to replace a grocery store tenant, in which case the landlord should confirm with the tenant the trigger date on which the applicable cure period began so that the landlord knows exactly when the remedies will kick in if a replacement tenant is not found. Furthermore, the lease may allow the landlord to replace a named tenant with a "comparable replacement" tenant, and will usually grant the landlord a set period of time in which to do so.

Be prepared to argue that the remedy is unenforceable.

In a fairly recent California case (*Grand Prospect Partners L.P. v. Ross Dress for Less*), the California Court of Appeals held that the tenant's rent abatement remedy in connection with an opening co-tenancy violation was an unenforceable penalty. While this case may be further reviewed, the landlord should be prepared to argue that an extreme remedy for a co-tenancy violation (*i.e.*, the ability to reduce rent by 50% or more) may be an unenforceable penalty if there is no relationship between what might be a miniscule loss in sales compared to a large rent reduction (or draconian lease termination). Such an argument may not succeed, but the merits should be considered, depending on the circumstances.

If there is a violation, be prepared to negotiate.

If the landlord determines that a violation does exist, the landlord may want to negotiate with the tenant to scale back the remedy provided in the lease. For example, rather than accepting a 50% reduction in rent, the landlord may propose expanding the tenant's premises at a reduced rate, increasing the tenant's signage rights (to the extent the landlord is able to do so), or reducing or capping common area costs for a set period. The tenant may not be receptive to any of these alternatives, but it does not hurt for the landlord to ask, especially if the landlord had previously granted certain concessions to the tenant in question.