

WHAT TO DO IF A TENANT CRIES CO-TENANCY FOUL

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 (such as Circuit City, Linens ‘N’ Things, Mervyn’s and/or Home Depot Expo), 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.

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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 any 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. While we are not aware of specific case law addressing the issue, an argument could potentially be made that an extreme remedy for a co-tenancy violation (i.e., the ability to reduce rent by 50% or to terminate the lease) 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.

The foregoing discussion addresses what a landlord should do if a co-tenancy violation has already occurred, or is alleged to have occurred. Of course, as a preemptive measure when granting co-tenancy rights in the first instance, the landlord should attempt to build in a variety of protections to any co-tenancy provision. Concepts to consider include: (1) insuring that a co-tenancy claim can be made only if the tenant has "clean hands" (i.e., is not in default), is operating from its premises, has not transferred its interest in the lease, and/or has suffered a drop in sales as a result of the violation, (2) granting the landlord the ability to find a replacement tenant (which should be defined as broadly as possible so as to give the landlord flexibility and a plethora of options) within a set period (i.e., 12 months) after the named co-tenant ceases operation, (3) providing a reasonable and lengthy cure period for the landlord to remedy the co-tenancy violation, and (4) requiring that any remedy involving the reduction in rent has a limited time frame (i.e., six months), after which period the tenant must either terminate the lease (a negotiable point) or resume paying rent at the rate then called for in the lease.

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