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Seminar 22

"Lookin' Out My Back Door – Lease Exit Strategies"

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by:

Thomas B. Cahill
Thomas B. Cahill Attorney at Law, P.C.
1155 South Washington Street, Suite 106
Naperville, Illinois 60540
tom@tbclaw.com

Howard K. Jeruchimowitz
Greenberg Traurig, LLP
77 West Wacker Drive
Suite 3100
Chicago, Illinois 60601
jeruchimowitzh@gtlaw.com

John H. Lewis
Hartman Simons & Wood LLP
6400 Powers Ferry Road, N. W.
Suite 400
Atlanta, Georgia 30339
john.lewis@hartmansimons.com

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Operating Covenants

Operating Covenants

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EXAMPLE 1 (Tenant's covenant to open and operate; failure to do so is default)

Tenant hereby acknowledges that Tenant's use of the Premises and ability to generate patronage to the Premises and the Shopping Center were all relied upon by Landlord and served as significant and material inducements contributing to Landlord's decision to enter into this Lease with Tenant. As such, Tenant agrees that, from and after the Rent Commencement Date, Tenant will continuously and uninterruptedly keep open and operate its business in the entire Premises fully fixtured, stocked, and staffed for the purpose specified in Section 1.1(k) and under the trade name specified in Section 1.1(a) with the public daily during such hours as are customary in the Shopping Center, subject to the terms and conditions of any franchise agreements with _____. Tenant's failure to operate as required by this Section shall be deemed an automatic Event of Default (without the requirement of any notice or cure period) under this Lease. If such an Event of Default occurs, then, for so long as neither this Lease nor Tenant's right to possession of the Premises under this Lease is terminated by Landlord, Tenant shall pay to Landlord on demand, in addition to the payment of all Rent (including, without limitation, Minimum Annual Rent) and other charges then due under this Lease and as Additional Rent hereunder, an additional amount equal to three (3) times the per diem Minimum Rent for each day during the period in which Tenant so fails to open for business. Such amount shall be considered additional rent due and payable hereunder due to the loss of traffic at the Shopping Center and percentage rent that may have been earned by Landlord during such period. Notwithstanding the foregoing, Tenant's payment of such amount shall not deprive Landlord of any other rights and remedies available to it hereunder, at law or in equity as a result of Tenant's Event of Default described herein.

EXAMPLE 2 (Tenant's covenant to open and operate; Landlord's covenant to operate center)

TENANT'S AND LANDLORD'S OPERATING COVENANT

Subject to the other provisions of this Section 4 and to the provisions of Sections 15 and 16 of Part I hereof and of Section 21 of Part II hereof:

Tenant will, from and after the opening for business in Tenant's Store Building and for the first _____ (_____) years of the Term after the opening date, continuously operate or cause to be operated in Tenant's Store Building a retail store, under the name of _____ or another name as _____ will be operating in the majority of its like retail stores in the same State [Commonwealth] [and for the remaining _____ (_____) years of the initial Term, continuously operate or cause to be operated in Tenant's Store Building a retail store] ("Tenant's Operating Covenant"). Tenant's Operating Covenant is subject to the following conditions: (i) Landlord is not in default; (ii) Mall Tenants occupying not less than seventy percent (70%) of Gross Leasable Area of the Mall are open and operating; and (iii) all other Major Stores have similarly covenanted to have a retail store, open and operating for at least as long as Tenant's Operating Covenant. If, at any time during Tenant's Operating Covenant, Landlord has not met all of the foregoing conditions, Landlord will have twelve (12) months after Notice from Tenant in which to cure the condition, or Tenant may cease to operate. Tenant's Operating Covenant will be personal to Landlord and not assignable, except to a successor Landlord who acquires the Demised Premises or to a mortgagee in possession. Tenant's Operating Covenant is conditioned upon Landlord not entering into an agreement with a third party where the third party has the right to enforce Tenant's Operating Covenant.

The hours of business, the number and types of departments to be operated in Tenant's Store Building, the particular contents, wares and merchandise to be offered for sale and the services to be rendered, the

methods and extent of merchandising and storage thereof, and the manner of operating Tenant's Store Building in every respect whatsoever shall be within the sole and absolute discretion of Tenant.

Tenant may operate Tenant's Store Building in whole or in part by licensees, subtenants or concessionaires; provided, however, that the appearance to the public shall be that of a retail Major Store consistent with the appearance of the majority of Tenant's comparable retail Major Stores in regional shopping centers being operated in the same State [Commonwealth].

Nothing contained herein shall be deemed to impose any radius or other restriction on the activities of Tenant outside of the Shopping Center.

Tenant will set its own hours and days of operations.

Notwithstanding anything contained in the Lease to the contrary, Tenant does not expressly or impliedly, directly or indirectly agree to operate a business in the Demised Premises. Tenant will set its hours and days of operation.

A cessation of business by Tenant, by any Major Store or by any Mall Tenant shall not be deemed a cessation of business for the purposes of this Part II, Section 4 if such cessation:

is occasioned by the making of repairs, alterations or renovations due to damage or destruction of the premises where such cessation of business occurs; or

is occasioned by an eminent domain taking; or

is caused by a condition which is less than three (3) consecutive months in duration.

Landlord shall for the first _____ (_____) Lease Years, and for so long thereafter as any two (2) of MJ1, MJ2, MJ3 or Tenant are operating, continuously operate the Shopping Center under the name "_____ Mall", in a first-class manner; and Landlord shall use its best efforts to keep all store space in the Shopping Center leased, and substantially used for retail and service purposes only.

EXAMPLE 3 (Tenant's covenant to open for a day; failure to do so is not a default)

Tenant agrees to fixture and stock the Building and to open the Building for business to the general public as a retail store under the trade name "_____" (or such other trade name under which Tenant's stores in _____ are then operated) for at least one (1) day on or before the later to occur of (i) _____, 20___, or (ii) the date which is _____ (__) months after _____. Any other provision of this lease to the contrary notwithstanding, however, Landlord acknowledges, covenants and agrees (x) that Tenant's failure to open for business as provided in this Section ___ shall not be a default under this lease, and (y) Landlord's sole right, remedy and recourse for Tenant's failure to open for business as provided in this Section ___ shall be as set forth in Section ___ hereof **[TYPICALLY A RECAPTURE PROVISION]**.

EXAMPLE 4 (no obligation to open or operate)

The Premises may be used for any lawful purpose. Without limiting the generality of the foregoing, Tenant shall have the right to use the entire Premises as Tenant sees fit in connection with the operation of business on the Premises. Notwithstanding any provision set forth in this lease or in any other documents, Tenant shall have no any obligation to construct any improvements on the Premises or to open or operate any business in the Premises.

CASE UPDATE:

1. *Operating Covenants Considered Top Priority*

In Rouse-Randhurst Shopping Center, Inc. v. J.C. Penney Co., 171 F. Supp. 2d 824 (N.D. Ill. 2001), the District Court placed operating covenants at the very top of the priorities scale and held that the anchor tenant of the shopping center breached the continuous operating covenant when it stopped paying rent after the termination

dates applicable if the tenant chose not to renew the lease. In 1990, J.C. Penney assumed the rights and obligations of a lease that originally ended in 1991, which had two key amendments. A 1981 amendment created a new termination date of June 30, 2001 with four consecutive five-year renewal options and also added a covenant of continuous operation under which the lessee agreed to operate continuously a department store on the premises until June 30, 1996 (five years before the then termination date of the lease). A 1989 amendment extended the term of the operating covenant for an additional nine years – until June 30, 2005 (four years beyond the 2001 expiration term).

J.C. Penney found the location unprofitable and ceased operations by the 2001 expiration term. The landlord claimed J.C. Penney was in violation of the continuous operation provision because J.C. Penney ceased operations before June 2005 and, therefore, it was entitled to damages. The court found the provisions clear and unambiguous and not in conflict because J.C. Penney could fulfill the terms of the lease by exercising its first option to extend the terms of the lease or by remaining in possession of the premises as a holdover tenant.

In addition to finding the provisions unambiguous, the District Court went on to emphasize the importance of operating covenants:

> In fact, any analysis of the dynamics of shopping center operations and their leases really places such operating covenants at the very top of the priorities scale.
>
> It is a truism that shopping centers rely for their success on the synergistic effect of their leases, both those running to key or anchor tenants (often department stores) and those running to more specialized lessees occupying smaller premises: Anchor tenants are looked to for the generation of foot traffic and hence of business for the other lessees, and in turn the anchor tenants hope for spillover business from persons who initially come to the center to shop at one or more smaller stores and who decide that, once there, they might as well see what the department store may be offering (sort of the equivalent of impulse buying at the supermarket). That phenomenon, coupled with the related fact that percentage rentals rather than guaranteed lease rentals make the difference between a successful center and a marginal or even failing center, make the prospect of an anchor tenant "going dark"—ceasing to operate—a calamity.

Therefore, even though it was questionable whether the landlord could require J.C. Penney to reopen its store, the landlord has not requested that relief but rather was entitled to damages for the breach of the continuous operating covenant.

2. *Implied Covenant Is Disfavored*

In an older case, the Minnesota Court of Appeals dealt with whether a lease created an implied covenant for a drug store to continue to operate in the shopping center for the duration of the lease. *See Plaza Assocs. v. Unified Dev., Inc.*, 524 N.W.2d 725 (Minn. Ct. App. 1995). The court made some key observations practitioners should keep in mind in drafting a lease and the impact of the lease on any implied covenant.

(i) As a general rule, the law does not favor implied covenants.

(ii) The courts will imply a covenant if necessary to effectuate the intent of parties. But "the implication must result from the language employed in the instrument or be indispensable to carrying out the intention of the parties into effect."

(iii) Courts are reluctant to impose the burden of a continuous operation clause in the absence of express language because it may "require the lessee to continue operating a business for a long period of time even if that business is incurring substantial losses."

(iv) Factors in that case weighed against an implied covenant for continuous operation:

(a) The implication of an operating covenant is less likely where the tenant is paying a "substantial" base rent and a relatively small percentage of gross receipts.

(b) When base rent is "substantial," an implied covenant is less likely if there is a correlation between the base rent and the fair market value of the lease at the time.

(c) The active and extensive negotiations of a lease by sophisticated parties also weighs against finding an implied covenant in a lease “since the parties were free to include whatever provisions they wished.”

(d) The failure of a landlord to use an express operating covenant where it has included the covenant in the lease of other tenants, which further weighs against finding an implied operating covenant because it makes clear that the landlord knew how to employ such a clause.

(e) A provision in a lease giving a tenant broad assignment or sublease rights is another factor preventing the implication of an operating covenant because it is inconsistent with an implied obligation to remain and do business.

(f) An implied covenant is less likely where there is no language detailing the scope of the business operation or the identity of the operator.

(g) An exclusive right to operate one’s business in the shopping center does not indicate an implied covenant to use the space for the full term of the lease.

Co-Tenancy Requirements

Co-Tenancy Requirements

1. Opening co-tenancy
2. Operating or ongoing co-tenancy
3. Determination of required tenants
4. Rights of tenant substitution
5. Remedies
   a) Notice and cure rights
   b) Right to delay opening, or to close
   c) Rent reduction
   d) Termination right
6. Sample provisions
   Case Update

EXAMPLE 1 (Opening co-tenancy)

Notwithstanding anything to the contrary contained herein, Tenant will not be required to initially open Tenant's Store Building to the public for business unless at least (i) two (2) other Major Stores and (ii) Mall Tenants occupying at least seventy percent (70%) of the Gross Leasable Area of the Mall are open for business to the public, nor under any circumstances shall Tenant be required to initially open Tenant's Store Building for business to the public during the Blackout Period.

EXAMPLE 2 (Opening co-tenancy)

1.1 Opening Co-Tenancy: Until (a) XYZ, or a single user equivalent replacement, is open for business containing approximately _____square feet and is located as shown on **Exhibit A**; and (b) at least __% of the Relevant GLA ("GLA" is herein defined as gross leasable area of the entire Shopping Center, Relevant GLA is defined below) is occupied by Retail Stores (as defined below) which are open for business; and (c) of the minimum __% of the Relevant GLA that is required to be open and operating, ___ (__) of the following ___ (__) named retailers must also be open and operating: _____ (the "Opening Co-Tenancy Requirement"), Tenant shall have the option of (i) delaying its opening and the Term of the Lease shall not commence until all such requirements are met, or (ii) opening for business, in which event, the Initial Lease Term shall commence on the date Tenant so opens and Tenant shall pay, in lieu of all Rents and Other Charges otherwise payable under this Lease, the lesser of (x) the Minimum Rent, or (y) ____ percent (__%) of Gross Sales, as defined in Section ___ ("Alternative Rent"), until the satisfaction of the terms and conditions of this Section 1.1.

As used herein, "Relevant GLA" shall mean the total GLA of the Shopping Center, excluding the XYZ space and the Leased Premises. "Retail Stores" shall mean retail stores and restaurants of the type typically found in first-class shopping centers in the geographic area where the Shopping Center is located, engaged primarily in the sale of goods, services, and food at retail, which operate seven (7) days per week. Retail Stores shall exclude, without limitation, the following: hair salon health club or gym, post office, office space of any kind, bowling alley, seasonal rentals, closeout or liquidation-type operations, second-hand or thrift store, or any other tenant which sells goods at retail only as an incidental use. Notwithstanding the foregoing, a full service spa and salon or a salon that is incidental to another retail use shall be permitted.

The terms and conditions of this Section 1.1 shall not be deemed to have been complied with until such time as notice certifying same by Landlord has been received by Tenant. Such notice shall set forth the GLA of the Shopping Center, the GLA of each store open for business in the Shopping Center and the opening date thereof, and shall include a site plan designating the stores open for business.

In the event that the terms and conditions of this Section 1.1 shall not have been met within eighteen (18) months from the earlier of either: (a) the date Tenant opens for business in the Leased Premises, or (b) the date Tenant would have otherwise been required to open for business but for the provisions of this Section 1.1, Tenant shall have a one time-right right, which must be exercised within thirty (30) days following the end of the 18-month period, to terminate this Lease and vacate the Leased Premises, in which event this Lease shall automatically terminate on the 60th day following Landlord's receipt of Tenant's termination notice, and thereafter this Lease shall be null and void and of no further force and effect, and neither party hereto shall have any further obligation hereunder, except for such matters that are designated to survive the termination hereof. If Tenant does not elect to terminate this Lease in a

timely manner as set forth above, then upon the 31st day following the end of such 18-month period, Tenant's right to terminate this Lease in accordance with Section 1.1 shall be null and void and Tenant shall commence payment of full Rent owed hereunder.

EXAMPLE 3 (Operating co-tenancy with immediate reduction in rent and immediate termination right)

CO-TENANCY. If, at any time during the TERM, as the TERM may be extended, the _____ [INSERT ANCHOR TENANT FROM LOI TERMS] ("Co-Tenant") ceases to be open to the public, fully staffed, stocked and operating in not less than ___ square feet of the Shopping Center (except for temporary store closings not exceeding sixty [60] days for remodeling, alterations or restoration work or in connection with casualty not exceeding one hundred eighty [180] days) (a "Continuing Co-Tenancy Violation"), then for any period thereafter that the Continuing Co-Tenancy Violation continues: (i) Annual Rent and TENANT'S Proportionate Share of the Common Area Maintenance Costs, Insurance and Taxes will be abated by Fifty Percent (50%); and (ii) TENANT may terminate this Lease by notifying LANDLORD in writing, which termination will be effective thirty (30) days after the date of such notice. If TENANT terminates this Lease as set forth in this Section, this Lease will terminate the terms of this Lease will be of no further effect, except for those obligations which survive termination of this Lease. If TENANT elects to terminate this Lease pursuant to this Section, then LANDLORD shall reimburse to TENANT the Unamortized Reimbursement Amount within thirty (30) days from the date of such termination, which obligation shall survive termination of this Lease. The "Unamortized Reimbursement Amount" shall mean the unamortized portion (as of the date of termination) of the sums expended by TENANT as set forth in TENANT'S books and records for the design, permitting and construction of TENANT'S improvements in and to the PREMISES according to the Approved Plans and any subsequent leasehold improvements, with amortization to be on a straight-line basis over ten (10) years commencing upon the date of each applicable expenditure. The total sums expended by TENANT in performing TENANT'S design, permitting and construction of TENANT'S improvements in and to the PREMISES according to the Approved Plans and any subsequent leasehold improvements will be reflected in a written itemization provided by TENANT at the same time as TENANT'S termination.

EXAMPLE 4 (Operating co-tenancy with immediate rent reduction, opportunity for Landlord to cure, and one-time future termination right)

1.1 Provided that Tenant (i) is not in monetary default of this Lease beyond the expiration of all applicable notice and cure periods and (ii) is open and operating for business in the Leased Premises (except if due to casualty, condemnation, force majeure or remodeling which is being diligently pursued to completion), a "Operating Co-Tenancy Event" shall occur if for any reason: (a) XYZ, or a single user equivalent replacement department store, is not conducting business in the entire XYZ space as shown on **Exhibit A**, or (b) at least ___% of the Relevant GLA (excluding the XYZ space and the Leased Premises) is occupied by Retail Stores which are open for business; provided, however, that if an Operating Co-Tenancy Event results from (i) from a casualty or condemnation, the Operating Co-Tenancy Event shall not be deemed to occur until one hundred eighty (180) days after the date upon which XYZ (or its single-user equivalent replacement) ceases to conduct business or (ii) a remodeling or renovation, the Operating Co-Tenancy Event shall not be deemed to occur until sixty (60) days after the date upon which XYZ (or its single-user equivalent replacement) ceases to conduct business. Upon the occurrence of any Operating Co-Tenancy Event, Rent payments due hereunder (however defined) shall abate until the date that both the Operating Co-Tenancy Event has ceased to exist and Landlord has so notified Tenant. During the period of such abatement, Tenant shall pay monthly, in arrears, in lieu of all Rents and Other Charges otherwise payable under this Lease, ____ percent (__%) of Gross Sales (as defined in Section ___), which for purposes of this Section 1.1 shall be deemed Alternative Rent.

In the event that Tenant has been paying Alternative Rent for eighteen (18) consecutive months hereunder as a result of an Operating Co-Tenancy Event, Tenant shall have the one-time right (with respect to that particular Operating Co-Tenancy Event) which must be exercised within thirty (30) days following the end of the eighteen (18) month period, to terminate this Lease and vacate the Leased Premises, in which event this Lease shall automatically terminate on the 60th day following Landlord's receipt of Tenant's written termination notice (and Tenant shall have the right to pay Alternative Rent up until the date of termination). If Tenant does not elect to terminate this Lease in a timely manner as set forth above, then upon the 31st day following the end of such 18-month period, Tenant's right to terminate this Lease in accordance with this Section 1.1 (and that particular Operating Co-Tenancy Event) shall be null and void and Tenant shall commence payment of full Rent owed hereunder. The foregoing rights shall apply to any replacement stores for those noted in (a) and (b) above.

Tenant shall notify Landlord at any time of the date which Tenant believes to be the date on which an Operating Co-Tenancy Event has occurred ("Tenant's Notice"), and in the event that Landlord fails to notify Tenant within thirty (30) days after receipt of Tenant's Notice that Landlord disputes the date set forth in Tenant's Notice, and Landlord fails to respond to Tenant after five (5) additional days following a second written notice provided by Tenant, the date set forth in original Tenant's Notice shall be irrevocably deemed to be the date upon which the Operating Co-Tenancy Event occurred and Tenant's rights hereunder shall be effective as of the date set forth in Tenant's Notice. From time to time, Landlord agrees to promptly respond to inquiries from Tenant concerning the occupancy of the Shopping Center, including any particular premises.

EXAMPLE 5 (Combination opening and operating co-tenancy provision, with go-dark/termination right)

Go-Dark Provision. Tenant will not be required to initially open the Premises to the public for business unless Landlord meets the following minimum levels of co-tenancy ("Co-Tenancy") by having other tenants open for retail business: (i) two (2) Major Stores; and (ii) other tenants occupying at least sixty percent (60%) of the Gross Leasable Area of the Shopping Center. Co-Tenancy shall exclude the Premises and shall include all other Gross Leasable Area shown on the Site Plan. If at any time after Tenant opens the Premises for business, the Co-Tenancy requirements are not met, Tenant may notify Landlord in writing, and Landlord shall have six (6) months to cure such deficiency. If Landlord fails to cure the deficiency within the 6-month period, then, in addition to other remedies accorded Tenant by law, Tenant may: (i) terminate this Lease at any time, upon Notice to Landlord, and Tenant will be released from all further obligations under this Lease[; or (ii) abate minimum rent hereunder. If the Co-Tenancy requirements are not met and Tenant elects to abate minimum rent, Tenant shall pay rent ("Alternate Rent") in an amount equal to the lesser of three percent (3%) of gross sales, or the minimum rent, until other tenants are open and operating in sufficient amounts to meet the Co-Tenancy requirements.] [If, the Co-Tenancy requirements are not met, within six (6) months after Tenant begins paying Alternate Rent, Tenant shall have the right, to be exercised at any time before the Co-Tenancy requirements are met to terminate this Lease upon thirty (30) days written notice to Landlord. If this Lease is terminated, all rent and other charges payable by Tenant hereunder shall be prorated through such date of termination. If Tenant does not elect to terminate this Lease, then [Tenant may continue to pay Alternate Rent] [minimum rent shall cease to abate, and Tenant shall pay rent in an amount equal to the minimum rent set forth in Article]. Landlord shall not be deemed to have cured a failure to meet a Co-Tenancy requirement until Landlord has notified Tenant in writing of the name and opening date of the replacement tenant(s). If Tenant elects to open the Premises for business before the Co-Tenancy requirements are met, then, in lieu of minimum rent, Tenant shall have the right to pay "Alternate Rent", until the Co-Tenancy requirements are met. On or before the twentieth (20^{th}) day of each calendar month during such period, Tenant shall submit a statement of its Gross Sales for the preceding calendar month and shall tender payment of the Alternate Rent provided for herein. All other terms and conditions shall remain as set forth in this Lease. The terms of this provision shall not apply if there is damage by fire or other casualty or a partial taking by eminent domain.

CASE UPDATE:

1. *Grand Prospect Case – Rent Abatement Unenforceable Penalty*

In a case of first impression, the California Court of Appeal ("Court") has ruled on the enforceability of a co-tenancy clause in a retail lease. *See Grand Prospect Partners, L.P. v. Ross Dress for Less, Inc.*, 182 Cal. Rptr. 3d 235 (Cal. Ct. App. 2015). In that case, the Court held that (1) the subject co-tenancy clause was not unconscionable, (2) the termination remedy for failure of the co-tenancy condition was enforceable because it was negotiated by two sophisticated parties and because the conditions triggering the termination right were not under the control of the landlord or the tenant, and (3) the rent abatement remedy was an unenforceable penalty because the rent that the tenant did not pay had no reasonable relationship to the tenant's anticipated harm.

Grand Prospect Partners, L.P. ("Grand Prospect" or "Landlord"), as the owner and operator of the Porterville Marketplace shopping center, filed a lawsuit challenging the enforceability of provisions in its lease with Ross Dress for Less, Inc. ("Ross" or "Tenant").

Section 1.7.1 of the Lease required Mervyn's and Target to occupy no less than 76,000 and 126,000 square feet of leasable floor area, respectively, on Ross's commencement date. In addition, section 1.7.2 required 70 percent of the leasable floor area to the shopping center to be occupied by operating retailers. Section 1.7.1 of the Lease also included the following operating condition: "Provided that the Required Co–Tenancy set forth in Sections

1.7.1 and 1.7.2 is satisfied on the Commencement Date, during the remainder of the Term, the Required Co–Tenant shall be either Mervyn's or Target occupying no less than the Required Leasable Floor Area indicated in (a) and (b) above. The Required Co–Tenant may be replaced by a nationally or regionally recognized Anchor Tenant (as herein defined) reasonably acceptable to Tenant, operating in no less than the Required Leasable Floor Area of the Required Co–Tenant being replaced. An 'Anchor Tenant' is a national retailer with at least one hundred (100) stores or a regional retailer with at least seventy-five (75) stores occupying no less than the Required Leasable Floor Area of the Required Co–Tenant being replaced."

Section 6.1.3(b) of the Lease defined a "Commencement Date Reduced Occupancy Period" as beginning with the failure of one of the required tenants to be open for business on the commencement date of the Lease and continuing until cured. Because Mervyn's had closed its store, a "Commencement Date Reduced Occupancy Period" began. As a result, section 6.1.3(b) provided that Ross was not required to open its store for business. That section also stated that, "regardless of whether [Ross] opens for business in the Store, no Rent shall be due or payable whatsoever until and unless the Commencement Date Reduced Occupancy Period is cured." For purposes of this opinion, this term of the Lease is referred to as the "rent abatement provision".

Section 6.1.3(b) also provided Ross with an option to terminate the Lease conditioned upon (1) the Commencement Date Reduced Occupancy Period continuing for 12 months and (2) Ross giving 30 days' notice of termination prior to the expiration of the Commencement Date Reduced Occupancy Period. Section 6.1.3(b)'s reference to 12 months did not limit the free rent to the first 12 months of the Lease and did not limit the cure period to those months. Rather, the 12–month period identifies when Ross accrued an option to terminate the Lease.

In summary, the co-tenancy provision at issue conditioned Ross' obligation to open a store and pay rent on Mervyn's (a department store chain) operating a store in the shopping center on the commencement date of the lease. Grand Prospect, however, did not own Mervyn's parcel. The clause did not have any end date for the rent abatement, nor did it require Ross to pay any rent regardless of whether it was open and operating or not. The provision also granted Ross the option to terminate the lease if Mervyn's ceased operations and was not replaced at that location by an acceptable retailer within 12 months. This opening co-tenancy condition was not satisfied because Mervyn's filed for bankruptcy and did not open its store near the Porterville Marketplace. Ross then took possession of its space, but never opened for business, never paid rent, and terminated the lease after the 12-month cure period expired. Grand Prospect claimed that Ross was obligated to pay rent for the full term because the provisions authorizing rent abatement and termination were unconscionable or, alternatively, an unenforceable penalty.

The trial court agreed with Grand Prospect that the rent abatement and termination under the co-tenancy provision were unconscionable and an unreasonable penalty, and found that Ross breached the lease. The jury awarded $672,100 for unpaid rent and approximately $3.1 million in other damages caused by the termination. The California Appeals Court concluded that the co-tenancy provision was not procedurally unconscionable because: (1) the parties were sophisticated and experienced in the negotiation of commercial leases for retail space, (2) their negotiations involved several drafts of the letter of intent and subsequent lease, (3) the Landlord's decision to approach the Tenant first about renting the space was a free and unpressured choice, and (4) the Tenant's insistence on a co-tenancy provision during the negotiations did not make the lease a contract of adhesion or otherwise deprive the Landlord of a meaningful choice.

As to the remedies of rent abatement and termination for failure to satisfy the co-tenancy, each remedy was examined separately. As a general rule, the Court stated: "[A] contractual provision is an unenforceable penalty under California law if the value of the property forfeited under the provision bears no reasonable relationship to the range of harm anticipated to be caused if the provision is not satisfied."

Even though the remedies under the co-tenancy provision were negotiated by the parties, the trial court found, and the Court affirmed, that the rent abatement provision constituted an unreasonable penalty because (1) the Tenant did not anticipate it would suffer any damages from Mervyn's not being open on the lease commencement date and (2) the value of rent forfeited under the provision was approximately $39,500 per month. The Court held: "There is no reasonable relationship between $0 of anticipated harm and the forfeiture of $39,500 in rent per month and, therefore, the trial court correctly concluded the rent abatement provision was an unenforceable penalty."

As to the lease termination provision, California courts have adopted a specific rule that holds no forfeiture results from terminating a commercial lease based upon the occurrence of contingencies that (a) are agreed upon by sophisticated parties and (b) have no relation to any act or default of the parties. Based on those factors, the

Court disagreed with the trial court, and found that the termination provision did not create an unreasonable penalty.

The Court therefore modified the judgment to only award $672,100 for unpaid rent instead of damages of $3,785,714.86, and lowered the overall judgment with attorney fees from $4,701,990.83 to $1,588,375.97. On February 9, 2015, the Court denied both parties' petitions for rehearing. However, because the amount awarded for attorneys' fees was remanded to the trial court, the Court modified its judgment to the sum of $672,100 and directed the trial court to add the attorneys fees awarded by the trial court upon remand.

Some takeaways from the *Grand Prospect* case are: (1) the rent abatement provision allowed Ross to pay nothing and had no end date even if it opened and operated its store, but the outcome might have been different if the rent abatement had the more traditional percentage off (like 50%), was tied to anticipated sales, or set a definite time; (2) the outcome might have also been different if Grand Prospect had control over Mervyn's space to control whether Mervyn's occupied or operated its business or to find a replacement tenant; (3) the Court may have been swayed by the fact that Grand Prospect paid over $2.3 million in tenant improvements before Ross took possession of the leased premises (it is worth noting that if Ross would have been required to taken possession within a reasonable time after the improvements, there would not have been a co-tenancy failure); and (4) the case has opened the door in certain factual circumstances to striking down rent abatement for a co-tenancy failure if it bears no relationship to the harm of the tenant. To be enforceable, such rent abatement must be reasonably related to the lost sales, lost profits, or other damage a tenant anticipates it might suffer if the required co-tenant does not occupy the space or open for business.

2. *Other Cases That Have Found Co-Tenancy Remedies Enforceable*

Before *Grand Prospect,* other courts have typically found co-tenancy conditions and their remedies to be enforceable. For example, two federal court opinions in 2012 illustrate challenges to rent remedies for co-tenancy failures. In both cases, the courts enforced the rent remedies negotiated in the leases.

In *Old Navy, LLC v. Center Developments Oregon, LLC*, 2012 WL 2192284 (D. Or. June 13, 2012), the U.S. District Court for the District Court of Oregon upheld the tenant's rent remedy, that provided that when a "key store" closed, Old Navy was entitled to pay a lower rent of "two percent (2%) of all gross sales made in the premises for each month" or "the amount of minimum rent then applicable." Old Navy had the right to close its doors, but continue paying rent until it decided to reopen, and had the right to terminate the lease if the "Operating Requirements" were not met for more than nine months. The District Court found that such a provision would not be considered a liquidated damages provision, but rather a tiered rent structure triggered if a co-tenancy is not satisfied. The District Court, therefore, did not consider any evidence or argument that the remedy bore a relationship to Old Navy's anticipated or actual damages.

In *Hickory Grove, LLC v. Rack Room Shoes, Inc.*, 2012 WL 1836330 (E.D. Tenn. May 21, 2012), the United States District Court for the Eastern District of Tennessee found that the lease entitled the tenant to pay only 4% of gross sales or the Guaranteed Minimum Rent defined in the lease for a co-tenancy failure. When the shopping center lost a "key client," as defined in the lease, and replaced it with an unqualified tenant, Rack Room decided to stay at the shopping center based on a reduced percentage of sales for the co-tenancy failure. The landlord argued that the co-tenancy provision was punitive in nature and bore no relationship to actual damages suffered by Rack Room. The landlord even offered evidence that Rack Room experienced an increase in sales with the replacement. The District Court did not consider the evidence because: (1) the unambiguous language of the lease did not require the tenant to show decreased sales in order to invoke the co-tenancy provision; and (2) the landlord did not show any evidence of fraud or undue mistake or that the provision was unconscionable.

3. *Lesson of Careful Lease Drafting*

The case of *Kleban Holding Co., LLC v. Ann Taylor Retail, Inc.*, 2013 WL 6191904 (D. Conn. Nov. 26, 2013) is a good example of the need for careful lease drafting and construction. Ann Taylor leased retail premises in a shopping center in Fairfield, Connecticut. The lease contained a co-tenancy clause that provided:

(a) Opening: the delivery date did not occur until 80% of the retail area of the center was under construction and Borders and two specifically-named major retailers have executed leases, but the landlord may replace the other two specifically-named major retailers with a suitable replacement tenant.

(b) Operating: In the event that Borders or 50% of the retail space, excluding the tenant was not open and operating, the tenant was entitled to abate the rent and instead pay five percent of gross sales until the tenants meeting the foregoing requirements are again open and operating.

Although Borders timely opened and operated, it closed its store on May 16, 2011 in connection with its bankruptcy filing. The landlord replaced Borders with Book Warehouse, which was later replaced by a university bookstore. Two months after Borders vacated the space, Ann Taylor began paying the abated rent.

The landlord initiated the lawsuit seeking full rent under the lease. Ann Taylor contended the lease entitled it to pay reduced rent so long as Borders did not occupy the shopping center. The landlord contended that the lease must be read to forbid Ann Taylor from continuing to pay reduced rent upon the replacement of Borders with another retailer.

The district court agreed with Ann Taylor finding that the co-tenancy unambiguously provided that Ann Taylor was permitted to pay abated rent under two conditions (a) where Borders is not open and operating or (b) where 50 percent of the remaining retail space is not open and operating. The court further found that Borders could not be replaced by another tenant under section (a) because only the two specifically-named major retailers were replaceable and the lease was silent about Borders, and that under section (b) Borders is specifically listed to mean that Borders, Inc. must be operating. In addition, even though the lease separately provided that the landlord does not warrant that any particular tenant will remain at the center, there was no conflict with the co-tenancy that provided for abated rent if the particular tenant vacated the property.

Therefore, the Landlord was stuck with the abated rent because Border's was out of business.

Sales Kickouts

Sales Kickouts

1. Determination of sales threshold
2. Definition of gross sales; what's in and what's out
3. Exclusion of certain closures from measurement period
4. Recapture of tenant improvement expenses, leasing commissions, etc.
5. Sample provisions
   Case Update

EXAMPLE 1 (Sales kickout right including detailed definitions of Gross Sales inclusions and exclusions)

(a) In the event that Tenant's Gross Sales from the Demised Premises are less than NINE HUNDRED THOUSAND AND 00/100 DOLLARS ($900,000.00) during the fifth (5th) Lease Year, Tenant shall have a one-time right during the fifth (5th) Lease Year to terminate the Lease ("Termination Right"). Tenant may exercise the Termination Right at the end of the fifth (5th) Lease Year by delivering written notice ("Termination Notice") to Landlord during the ninety (90) day period ("Termination Period") immediately following the expiration of the fifth (5th) Lease Year. All Rental and Additional Rental due under this Lease shall be payable by Tenant through and including the Termination Period. Additionally, as a condition to such Termination Right Tenant shall pay Landlord a fee ("Termination Fee") equal to the unamortized portion of all costs of Landlord Work and brokerage commissions incurred by Landlord in connection with this Lease ("Lease Costs") such Lease Costs being amortized over a one hundred twenty (120) month period provided such Lease Costs do not exceed $100,000.00. Notwithstanding anything herein to the contrary, Tenant's Termination Right is expressly conditioned on Tenant's satisfaction of each and every one of the following conditions: (i) Tenant shall not be in default of the Lease beyond any applicable notice and cure periods at the time that it delivers the Termination Notice; (ii) Tenant shall have continuously operated its business as a fully stocked and staffed operation in accordance with Article 1.01 of the Lease for all periods (excluding any such periods associated with casualty, condemnation or remodeling) up to and including the date that it delivers the Termination Notice; (iii) Tenant shall have delivered the Termination Notice prior to the expiration of the Termination Period and (iv) Tenant shall have paid the Termination Fee together with all Rental and Additional Rental due and owing prior to the expiration of the Termination Period. Failure of Tenant to satisfy any of the conditions set forth in the immediately preceding sentence shall render the Termination Right null and void and shall not be effective notwithstanding any subsequent cure.

(b) Excluded from Gross Sales: (i) sales taxes collected directly from customers by Tenant, and any other tax, excise, use retailer's occupation or similar tax or duty which is levied or assessed against Tenant by any governmental authority based on sales of specific merchandise sold on, or the privilege or license to sell or distribute merchandise from the Premises, whether or not the amount thereof is passed on to or collected by Tenant from any purchaser thereof; (ii) the exchange of merchandise between the stores of Tenant, if any, where such exchanges of goods or merchandise are made solely for the convenient operation of the business of Tenant and not for the purpose of consummating a sale which has theretofore been made at, in, on or from the Premises, and/or for the purpose of depriving Landlord of the benefit of a sale which otherwise would be made at, in, on, from or upon the Premises; (iii) the amount of returns to shippers, manufacturers, suppliers or purveyors; (iv) the amount of any cash or credit refund made upon any sale where the merchandise was sold, or some part thereof, is thereafter returned by the purchaser and accepted by Tenant; (v) sales of furniture, fixtures, machinery and equipment; (vi) all sums and credits received in settlement of claims for loss or damage to merchandise; (vii) all returns and other cancellations, and allowances; (viii) amounts for merchandise furnished without additional charge for good will adjustments; (ix) receipts from vending machines, and public telephones; (x) receipts from the sale of merchandise or gift certificates and purchase coupons; however, the sale of merchandise made by Tenant from the Premises, paid for with gift certificates or purchase coupons, is included in Gross Sales, unless otherwise excluded; (xi) amounts credited on the purchase price because of employee or other discounts; (xii) unclaimed funds and property; (xiii) any amounts listed as "over ring" or similar connotation to denote a sale which was rung in error and for which no cash or credit was collected; (xiv) any amounts rung on Tenant's register as part of employee training and for which no cash or credit was collected; (xv) charity sales; (xvi) credit card use fees and direct expenses of credit card sales paid by Tenant to the third party issuers and/or processors of such credit cards; (xvii) uncollectible credit card charges, bank chargebacks for counterfeit currency or unnegotiable checks; (xviii) any interest or service charges received with respect to sales of merchandise or service; (xix) tips or other gratuities given by customers to Tenant's agents, employees or servants, whether such tips or other gratuities are automatically added to the customer's bill or given by the customer separate and apart from the bill; (xx) non cash donations to nonprofit, charitable or religious organizations; (xxi) the discounted portion of sales pursuant to the redemption of promotional coupons or similar vouchers; (xxii) sales of t shirts or other

promotional items bearing Tenant's trade name or logo not to exceed one (1%) percent of Gross Sales; (xxiii) the sale of employee uniforms; and (xxiv) charges for packaging and delivery or any similar service. Each charge or sale upon installment or credit shall be treated as a sale for the full price in the month during which such charge or sale shall be made (and the direct expenses of such credit card sales shall be deducted in such month) regardless of the time at which Tenant receives payment therefor.

[Alternate list of exclusions from Gross Sales Excluded from Gross Sales:

All returns and other cancellations, and allowances;

Rental Charges, including but not limited to, charges for or pursuant to rentals of automobiles, tools and other merchandise and equipment;

Charges to customers for or pursuant to services, deluxing, delivery, installation or inspection;

Amounts, debits or charges of, for or pursuant to maintenance or service agreements (currently known as "Maintenance Agreements"), or for replacement or repair parts of merchandise furnished without additional charge in connection with repairs or replacements pursuant to warranties, guarantees, good will adjustments or Maintenance Agreements;

All sales ordered through the use of or from _____ catalogs or filled through _____ catalog channels regardless of the place of order, payment or delivery;

Finance charges or other amounts in excess of Tenant's (or its concessionaires or licensees) cash sales price charged on, for or pursuant to sales made on credit or under a time payment or layaway plan;

The amount of all sales, use, excise, retailers occupation or other similar taxes, imposed in a specific amount of percentage upon, or determined by, the amount of sales, or sale, made from Tenant's Store Building;

Sales of departments, divisions or offices not located in Tenant's Store Building, even though administratively controlled therefrom;

Contractor Sales, as hereinafter defined, regardless of whether _____ maintains an office, showroom or samples for the merchandise, or whether made on or from the Tenant's Store Building;

Receipts from vending or weighing machines, amusement devices and public telephones;

Receipts from sales of tickets for admission to entertainment, sporting or other similar events, from sales of licenses issued by governmental agencies and from collection of utility bills and check cashing, gifts and prizes;

Receipts from the operation of eating facilities primarily available for employee use and not generally open to the public;

Receipts from the sale of merchandise or gift certificates and purchase coupons; however, the sale of merchandise made by Tenant from Tenant's Store Building, paid for with gift certificates or purchase coupons, is included in Net Sales, unless otherwise excluded;

Fees for building and like permits in connection with sales of merchandise or services;

Amounts credited on the purchase price of merchandise because of merchandise traded in, or employee or other discounts;

Unclaimed funds and property;

Sales made by Tenant's subtenants, concessionaires and licensees;

The amount of all governmentally-required levies for parking if passed on to customers;

Commissions or amounts received in conjunction with the sale, leasing or financing of real estate.

The phrase "Contractor Sales" means sales of goods or merchandise made to persons or entities other than the general public and including, but not limited to, sales of merchandise made to industrial, commercial or institutional purchasers or to governmental or quasi-governmental bodies, and sales of goods manufactured to the purchaser's specifications whether or not installed by Tenant.

EXAMPLE 2 (Sales kickout right after specified period)

1.1 Lease Termination by Tenant.

In addition to any other right of termination under this Lease and notwithstanding anything herein to the contrary, provided that Tenant (i) is not then in monetary or material non-monetary default under any of the provisions or covenants of the Lease beyond the expiration of applicable notice and cure periods, (ii) has been open and operating in the Premises for the Permitted Use and under the Trade Name (as further defined in Section ___) during the entire fifth (5th) Lease Year (excepting "Temporary Closures," AS hereinafter defined), and (iii) if Tenant does not achieve Gross Sales (as hereinafter defined) of at least _____ Dollars ($_____.00) during the fifth (5th) Lease Year (the "Minimum Sales Requirement"), then provided that Tenant shall pay Landlord the sum of $_____.00 (the "Termination Fee") prior to vacating the Leased Premises, Tenant may unconditionally terminate this Lease upon delivery of prior written notice to Landlord sent within sixty (60) days after the expiration of the fifth (5th) Lease Year, together with reasonable supporting documentation which evidences Tenant's Gross Sales for the fifth (5th) Lease Year. Landlord shall have the right to audit such Gross Sales in accordance with Section ___ to verify that the Minimum Sales Requirement has not been achieved. If Tenant exercises its right to terminate the Lease pursuant to this Section 3.1, the Lease shall terminate on the date set forth in such notice (not to be later than one hundred twenty (120) days following the expiration of the fifth (5th) Lease Year) as if such date were the originally scheduled expiration date of this Lease, and upon such termination, none of the parties hereto shall have any further obligation hereunder (except for those obligations specifically surviving Lease expiration or termination), and this Lease shall be deemed null and void and of no further force or effect. Tenant may deduct from the Termination Fee any credits then due and owing to Tenant under the Lease. Notwithstanding anything to the contrary contained or implied herein, Tenant's early termination shall not be effective unless Landlord receives Tenant's written notice and supporting documentation (being a statement of Gross Sales for the 5th Lease Year) and the Termination Fee within the time periods set forth above.

As used herein, "Temporary Closures" shall mean that Tenant is closed as a result of repairs following a casualty, condemnation, force majeure, Landlord's intentional or negligent acts, subletting or assignment, not to exceed 180 consecutive days in each such instance.

If Tenant is not continuously operating for business during any portion of the fifth (5th) Lease Year due to any Temporary Closure, then Tenant's Gross Sales for the same or similar period of time that Tenant was continuously operating during the previous Lease Year shall be added to Tenant's Gross Sales for the fifth (5th) Lease Year for purposes of determining whether Tenant achieved Gross Sales of at least _____ Dollars ($_____.00) during the fifth (5th) Lease Year.

CASE UPDATE:

It is important to remember that a tenant will not be able to exercise a gross sales kickout if the tenant is in default of another provision of the lease and the provisions contains language that the tenant cannot be in default of another provision of the lease. In *Almeda Mall, L.P. v. Shoe Show, Inc.*, 2010 WL 2218379 (S.D. Texas June 2, 2010), the lease contained the following "Gross Sales Kickout" clause:

Tenant shall have the right to terminate this Lease upon sixty (60) days written notice which must be given, if at all, within sixty (60) days of the end of the fifth (5th) Lease Year, if Tenant's Gross Sales do not exceed One Million and 00/100 Dollars ($1,000,000.00) in the fifth (5th) Lease Year. Tenant's right to terminate the Lease ... is contingent on the following: (i) **Tenant not being in default of the Lease at the time the termination notice is mailed and at the time the termination becomes effective**; (ii) Tenant having continuously operated using good faith efforts to maximize its Gross Sales throughout the first five (5) Lease Years of the term ... (Emphasis added).

The tenant, Shoe Show, invoked the clause ns the fifth year of the lease because the store's sales under the trade name "the Shoe Dept." had not exceeded $1 million in the fifth year of the lease term. The landlord claimed that the tenant was operating another shoe store in a nearby shopping center two miles away under the trade name "Shoe Show" in violation of the competition clause under the Lease. The District Court found that "the Shoe Dept." and "Shoe Show" were substantially similar trade names and, therefore, the tenant was in default under the lease and could not invoke the Gross Sales Kickout clause. However, the Fifth Circuit Court of Appeals, in *Almeda Mall, L.P. v. Shoe Show, Inc.*, 649 F.3d 289 (5th Cir. 2011) reversed the District Court (with one dissenting judge) and found that "Shoe Show" was not substantially similar to "the Shoe Dept," and did not constitute a default by the Lessee under the Lease and thus did not prohibit Shoe Show from exercising its option to terminate the Lease at the end of its fifth year.

Subletting and Assignment

Subletting and Assignment

1. Internal
2. Third Party
3. Issues to Consider when negotiating the initial lease
   a) Estoppel
   b) Non-Disturbance
   c) Cure Rights

EXAMPLE 1 (Permitted transfers and recognition agreement)

Permitted Transfers. Notwithstanding anything to the contrary contained herein, neither (i) the transfer of stock or other voting or ownership interests in Tenant or any of its Affiliates (as hereinafter defined) (including any merger or consolidation involving Tenant or any of its Affiliates), nor (ii) a Permitted Transfer (as hereinafter defined) shall constitute an assignment, transfer or sublease for purposes hereof, and shall not be subject to the terms of the preceding sections, including, but not limited to, the requirement of Landlord's consent or execution of an assumption agreement. An "Affiliate" of any person or entity is a person or entity that directly or indirectly through one or more intermediaries controls, is controlled by or is under common control with the first such person or entity. The word "control" means the power, directly or indirectly, by voting rights, contract or otherwise, to direct or cause the direction of the management or policies of a person or entity. "Permitted Transfer" shall mean: (a) any assignment of this Lease to any Affiliate of Tenant, (b) any assignment or sublease executed in connection with a sale or transfer of all or substantially all of the assets of the Tenant or an Affiliate of Tenant, (c) any sublease of the Premises (or any portion thereof) to an Affiliate of Tenant, and/or (d) a license to use a portion of the Premises granted to any contractor, consultant, service provider, joint venture partner or client of Tenant which is occupying space in the Premises for purposes related to the conduct of Tenant's business therein (any of the foregoing parties listed in this subparagraph (d), a "Tenant Third Party Licensee"); provided, however, that Tenant shall be responsible for, shall fully insure against, and shall indemnify Landlord and hold it harmless from, any and all liability for any loss, damage or injury to person or property, arising out of use, occupancy or operations of any such Tenant Third Party Licensee in accordance with Subsection 11.4. Notwithstanding anything to the contrary in this Subsection 8.10, Tenant shall at all times remain fully responsible and liable for the payment of rent and the performance and observance of all of the other obligations of the Tenant under the terms, conditions and covenants of this Lease regardless of any assignment or subletting (including, but not limited to, a Permitted Transfer).

Lease Recognition Agreement. Landlord agrees, upon request of Tenant, to execute and deliver a lease recognition and non-disturbance agreement in form and substance reasonably satisfactory to Landlord ("Lease Recognition Agreement") for each Qualified sublease (as hereinafter defined). Tenant shall, upon request of Landlord and as a condition to Landlord executing a Lease Recognition Agreement, submit to Landlord sufficient information to enable Landlord to verify that the sublease for which a Lease Recognition Agreement is being requested is a Qualified Sublease. For this section a "Qualified Sublease" shall mean a sublease which is executed after the date hereof with a subtenant who is a person or entity which has a credit rating or creditworthiness (taking into account any security deposit, letter of credit or other credit enhancement provided by such subtenant) which is reasonably acceptable to Landlord.

EXAMPLE 2 (Subtenant's right to cure Sublandlord's default under the Prime Lease)

It is agreed that, if Sublandlord is in default of the provisions of the Prime Lease, Subtenant may, but need not, cure the default specifically on behalf of and for the account of Sublandlord, in which case all reasonable costs and expenses incurred by Subtenant to cure the default shall be paid to Subtenant within thirty (30) days after written demand delivered to Sublandlord accompanied by supporting data in reasonable detail. Subtenant may not exercise its right to cure Sublandlord's default under the Prime Lease unless (i) Subtenant delivers prior written notice (" Subtenant's Cure Notice ") to Sublandlord stating, in reasonable detail, the circumstances of such default and (ii) Sublandlord either (A) fails to deliver to Subtenant in a timely manner following receipt of Subtenant's Cure Notice a written notice (" Sublandlord's Response ") stating Sublandlord's intent to timely and fully cure such default, or (B) if after delivering to Subtenant Sublandlord's Response, Sublandlord fails to cure or commence to cure such default within the time period required to cure the same as set forth in the Prime Lease, less two (2) days. In so curing Sublandlord's default, Subtenant shall not be deemed to have waived any of its rights, nor to have released Sublandlord from any of its obligations under this Sublease. It is further

agreed that Subtenant may cure Sublandlord's default under the Prime Lease on and for Subtenant's own account to preserve its interest in this Sublease.

EXAMPLE 3 (Prime landlord's right to collect rent directly from subtenant following a default by sublandlord)

If an Event of Default occurs while the Premises or any part thereof are subject to a Transfer, then Landlord, in addition to its other remedies, may collect directly from such transferee all rents becoming due to Tenant and apply such rents against Rent. Tenant authorizes its transferees to make payments of rent directly to Landlord upon receipt of notice from Landlord to do so following the occurrence of an Event of Default hereunder. Tenant shall pay for the cost of any demising walls or other improvements necessitated by a proposed subletting or assignment.

EXAMPLE 4 (Subtenant's agreement to attorn to prime landlord)

Each sublease by Tenant hereunder shall be subject and subordinate to this Lease and to the matters to which this Lease is or shall be subordinate, and each subtenant by entering into a sublease is deemed to have agreed that in the event of termination, re-entry or dispossession by Landlord under this Lease, Landlord may, at its option, take over all of the right, title and interest of Tenant, as sublandlord, under such sublease, and such subtenant shall, at Landlord's option, attorn to Landlord pursuant to the then executory provisions of such sublease, except that Landlord shall not be (1) liable for any previous act or omission of Tenant under such sublease, (2) subject to any counterclaim, offset or defense that such subtenant might have against Tenant, (3) bound by any previous modification of such sublease not approved by Landlord in writing or by any rent or additional rent or advance rent which such subtenant might have paid for more than the current month to Tenant, and all such rent shall remain due and owing, notwithstanding such advance payment, (4) bound by any security or advance rental deposit made by such subtenant which is not delivered or paid over to Landlord and with respect to which such subtenant shall look solely to Tenant for refund or reimbursement, or (5) obligated to perform any work in the subleased space or to prepare it for occupancy, and in connection with such attornment, the subtenant shall execute and deliver to Landlord any instruments Landlord may reasonably request to evidence and confirm such attornment. Each subtenant or licensee of Tenant shall be deemed, automatically upon and as a condition of its occupying or using the Premises or any part thereof, to have agreed to be bound by the terms and conditions set forth in this Section, the provisions of this Section shall be self-operative, and no further instrument shall be required to give effect to this provision.

EXAMPLE 5 (Landlord and Tenant's agreement to execute estoppels)

Landlord and Tenant shall execute and deliver to each other, at such time or times as either Landlord or Tenant may request, a certificate stating: (i) whether or not the Lease is in full force and effect; (ii) whether or not the Lease has been modified or amended in any respect, and submitting copies of such modifications or amendments, if any; (iii) whether or not there are any existing defaults under this Lease to the knowledge of the party executing the certificate, and specifying the nature of such defaults, if any; and (iv) such other information as may be reasonably requested. The aforesaid certificate(s) shall be delivered to Landlord or Tenant, as the case may be, promptly upon receipt of a written request therefor, but in no event more than ten (10) days following receipt of such request.

Exclusives and Use Restrictions

Exclusives and Use Restrictions

1. Effect of exclusives and restrictions on lease negotiations
2. Willful landlord violation vs. violation by rogue tenant
3. Remedies
   a) Notice and cure rights
   b) Rent/reduction/abatement
   c) Percentage rent only
   d) Right of action against third party
   e) Termination right
4. Sample provisions
   Case Update

EXAMPLE 1 (Broad, tenant-oriented exclusive)

Tenant's Exclusive Use.

(a) No portion of the Shopping Center (other than the Premises) nor any other property now or hereafter owned or leased by Landlord or any Affiliate (as defined below) of Landlord located within _____ (__) miles of the Premises (the **"Adjacent Controlled Property"**) shall be used for a _____ or for any business which sells, displays, leases, rents or distributes the following items or materials, individually or in any combination: **[LIST SPECIFIC PROTECTED ITEMS]**, or other products generally sold in a _____, except for the incidental sale of such items. An "incidental sale of such items" is one in which there is no more than the lesser of (i) _____ percent (__%) of the total floor area of such business; or (ii) _____ (_____) square feet of sales and/or display area, relating to such items individually or in the aggregate. The restriction established in this paragraph is hereinafter referred to as **"Tenant's Exclusive Use Right."** As used herein, the term "**Affiliate**" shall mean any person or entity in control of, controlled by or under common control with, Landlord. For purposes of this provision, a person or entity shall be deemed to be in control of another if such person or entity owns or has beneficial ownership of fifty percent (50%) or more of the ownership interests of the entity in question or such person or entity owns less than fifty percent (50%) of such ownership interests, but actually controls the management of such entity.

(b) Landlord acknowledges that the grant of Tenant's Exclusive Use Right was a material inducement to Tenant entering into this Lease and agrees that Tenant shall have the right to enforce Tenant's Exclusive Use Right by appropriate injunctive or other equitable relief in addition to any and all remedies at law, provided that Landlord shall reimburse Tenant for all expenses incurred by Tenant in enforcing Tenant's Exclusive Use Right, including reasonable attorney's fees. In the event that a violation of Tenant's Exclusive Use Right continues for thirty (30) days after Tenant's notice to Landlord, Tenant shall be entitled to abate Rent and other charges due hereunder until such time as such violation ceases; provided, however, if the violation occurs by virtue of another tenant violating the terms of its lease, the thirty (30) day period shall be extended to one-hundred eighty (180) days provided the Landlord promptly commences its efforts to cause the offending tenant to cease such violation (which efforts shall include the filing of suit). If such violation has not ceased within one-hundred eighty (180) days, Tenant shall at any time thereafter be entitled to terminate this Lease by written notice to Landlord, whereupon this Lease shall be of no further force or effect and neither party hereto shall have any further rights, duties, or liabilities hereunder other than those rights, duties and liabilities which have arisen or accrued hereunder prior to the effective date of such termination.

(c) The restrictions set forth in this Section shall not apply to any tenant under any lease pertaining to the Shopping Center or the Adjacent Controlled Property existing as of the Effective Date (determined without regard to any amendments thereto made after the Effective Date) during the term of such other tenant's lease (including all renewals or extensions pursuant to options contained in such lease as of the Effective Date), if such lease does not give the landlord thereunder the legal right to enforce Tenant's Exclusive Use Right against such tenant. However, to the extent that such lease gives the landlord thereunder the legal right to enforce Tenant's Exclusive Use Right against such existing tenant, such landlord shall do so. By way of example, if another tenant's lease does not include any express reference to Tenant's Exclusive Use Right, but such lease restricts the tenant to a particular use which is different than and does not overlap with Tenant's Exclusive Use Right, then such landlord would be required to prohibit such other tenant from violating Tenant's Exclusive Use Right.

EXAMPLE 2 (More narrowly defined exclusive, with specific carve-outs)

> Until the earlier of (i) _____, 20__, or (ii) the date that Tenant ceases to own and operate, or does not own or operate, a _____ Store (as defined below) within _____, no portion of the Property shall be used, leased, occupied or licensed for use as a _____ Store. As used herein, a "_____Store" shall mean a _____ store, whose primary business is the sale of **[GENERAL DESCRIPTION OF PROTECTED ITEMS]** customarily sold in _____, and which store contains more than _____ square of floor area or is a combination of a _____ store and _____ regardless of the square footage thereof. Notwithstanding anything to the contrary herein, the foregoing shall not restrict the use, lease, occupancy or licensing of the property as (i) a wholesale club store operation, such as, without limitation, stores that are currently operated as "_____" or "_____" or any other similar wholesale store operation, or (ii) a department store that sells _____ products such as, without limitation, stores that are currently operated as a "_____", "_____", "_____", or "_____" or any other similar department store; provided that the same does not devote more than _____ square feet of floor area to the sale of _____ products.

CASE UPDATE:

The Eleventh Circuit Court of Appeals in the *Winn-Dixie Stores, Inc. v. Dolgencorp, LLC* case, 746 F.3d 1008 (2014) rendered what many consider a major and impactful decision in the retail industry on the law of exclusives.

Relevant Background

1. Winn-Dixie has about 500 grocery stores throughout the Southeast and is often co-tenants with discount retailers, such as Dollar General, Dollar Tree and Big Lots, in shopping centers. These discount retailers had been increasing sales in consumable goods, such as food, paper, cleaning, and health and beauty products.

2. Winn-Dixie has an exclusivity lease provision known as "Grocery Exclusives" that generally prohibits any other tenant co-located with a Winn-Dixie from selling "staple of fancy groceries, meats, fish, vegetables, fruits, bakery goods, dairy products or frozen foods," except for the sale of such grocery items that constitute less than 500 feet of "sales area".

3. In 2011, Winn-Dixie filed a lawsuit to enforce its exclusivity lease provisions against 97 Dollar General, Dollar Tree and Big Lots stores in the U.S. District Court for the Southern District of Florida. Winn-Dixie alleged that these stores, located in Alabama, Florida, Georgia, Louisiana and Mississippi, violated Winn-Dixie's lease with its landlords by selling groceries, which includes these consumable goods, in a sales area that was restricted to Winn-Dixie sales.

4. Notably, Winn-Dixie did not sue the landlords with whom it had contracts, instead suing only its co-tenant competitors.

5. Winn-Dixie alleged over $90 million in lost profits as a result of the violation of the Grocery Exclusives.

District Court Opinion

1. Winn-Dixie could sue the co-tenants in Florida, Georgia and Alabama because the covenants run with the land, but Winn-Dixie could not maintain its claim for stores in Louisiana because exclusives do not run with the land and in Mississippi because privity of estate must exist between the person enforcing the covenant and the person upon whom the covenant is being imposed upon.

2. For the stores in Florida, Georgia and Alabama, the District Court found the terms "staple or fancy groceries" and "sales area" ambiguous and, therefore, must be construed narrowly and against the party enforcing the restrictive covenant.

3. Therefore, the District Court found that "staple or fancy groceries" be limited to food and nonalcoholic beverages, and that "sales area" be limited to the footprint of the display unit, excluding aisle space.

4. Based on the narrow interpretation, of the 97 stores, the District Court entered injunctive relief as to only 14 locations.

5. The District Court refused to award compensatory damages to Winn-Dixie, finding its' damages expert's opinion too speculative. It refused to award punitive damages because the "grocery exclusive sought to be enforced against the Defendants are rife with ambiguities and the scope of their restrictions are uncertain at best."

Eleventh Circuit Opinion

1. The Court of Appeals agreed with Winn-Dixie and the District Court that the covenants run with the land and that under the local laws on Florida, Georgia and Alabama, the covenant were enforceable against cotenants.

2. The Court of Appeals disagreed with the District Court's finding that "staple or fancy groceries" and "sales area" were ambiguous or the narrow definitions given to t \hem. Rather, relying on dictionary definitions, the Court of Appeals found that "groceries" includes food and "many household supplies (as including soap, matches, and paper napkins)" and "sales area" includes "fixtures and their proportionate aisle space."

3. Therefore, the Court of Appeals remanded the case for the District Court to revisit the judgment as to 41 Florida stores, 11 Alabama stores and two Georgia stories based on the broader definition and to be interpreted in accordance with the appropriate law of each of the states.

4. However, as to the remaining 43 stores, the Eleventh Circuit affirmed the District Court's denial of relief.

5. The Court of Appeals agreed that the covenants were unenforceable against the co-tenant under the laws of Louisiana and Mississippi.

6. The court also affirmed the District Court's finding that Winn-Dixie could not enforced a covenant against one Dollar General store that has signed its lease prior to Winn Dixie's lease, noting that "a party who takes an interest in property before a restriction is created, and who lacks notice of that limitation, is not bound by a restrictive covenant,

7. Finally, the Court of Appeals agreed with the District Court on compensatory damages because of inadmissibility of Winn-Dixie's expert, in part, because the analysis did not answer the precise question of whether "Winn-Dixie suffered damages as a result of Defendants' sales of groceries in a larger sales area than permitted by the restrictive covenants." Also, the Court of Appeals found that punitive damages were not appropriate because the Defendant did not act in an intentional or "grossly negligent manner"; rather "Defendants conducted themselves in accordance with a reasonable interpretation of the grocery exclusives."

Takeaways

1. State law is determinative whether an exclusive can be enforced against a co-tenant. Certain states the covenant does not run with the land or the state law requires privity with the person the exclusive is being imposed upon. In states where the exclusivity is a covenant that runs with the land, tenants who share space with should perform due diligence to make sure they are in compliance with covenants regardless if they are parties to the leases.

2. The Court of Appeals' more expansive definitions of "groceries" and "sales area" will allow supermarkets to more easily enforce exclusives against co-tenants and make it more difficult to compete for consumable products if the supermarket insists on exclusive rights.

3. Even if a co-tenant is violating the exclusive, proving lost profits remains difficult.

Negotiated Lease Terminations

Negotiated Lease Terminations

1. Reason for termination
2. Method of termination; tying up loose ends
3. Contingencies and payments
4. Sample provisions

EXAMPLE 1 (Landlord early termination right included in lease)

Termination of Lease. Lessee may terminate this Lease upon thirty (30) days written notice to the Lessor.

EXAMPLE 2 (Tenant early termination right included in lease)

ACCELERATION OPTION

17.1 Acceleration. Tenant shall have the option to accelerate the termination date of this Lease in its entirety (the "Acceleration Option") to the last day (the "Accelerated Termination Date") of the 60th full calendar month following the Commencement Date by delivery of written notice to Landlord (the "Acceleration Notice") given no later than the last day of the 48th full calendar month following the Commencement Date, time being of the essence. Tenant's Acceleration Notice shall be accompanied by one-half (1/2) of the Acceleration Fee (as hereinafter defined), and the balance of the Termination Fee shall be due no later than ninety (90) days prior to the Accelerated Termination Date. If not so exercised, Tenant's Acceleration Option shall thereupon expire.

17.2 Surrender of Premises. If Tenant delivers its Acceleration Notice according to the terms and conditions of Section 17.1 including but not limited to payment of the Acceleration Fee, then, subject to the terms and conditions of this Article 17, effective as of the Accelerated Termination Date, this Lease shall terminate, and Tenant shall be and remain liable to pay to Landlord of all Rent and other sums due or accrued, and to perform and keep all covenants, agreements and obligations under this Lease to be performed, paid and kept by Tenant prior to the Accelerated Termination Date. If Tenant fails to completely vacate the Premises and surrender possession thereof to Landlord according to the terms and conditions of this Lease on or prior to the Accelerated Termination Date, such failure shall be treated as a holding over by Tenant, and Landlord shall be entitled to all of its remedies therefor pursuant to Article 12 of this Lease.

17.3 Acceleration Fee. If Tenant exercises its Acceleration Option, Tenant shall pay Landlord a fee, which shall not be construed as a penalty, equal to Landlord's transaction costs (consisting exclusively of, Landlord's Contribution, broker commissions, the Rent Credit and the Abatement) remaining unamortized as of the Acceleration Termination Date, as reasonably calculated by Landlord amortized over the period commencing on the Commencement Date and ending on the Accelerated Termination Date including an interest rate of eight percent (8%) per annum (the "Acceleration Fee"). The Acceleration Fee shall be increased if and when the Premises are expanded from time to time. If Tenant fails to pay either installment of the Acceleration Fee according to the foregoing, time being of the essence, Landlord may elect, upon notice to Tenant to declare the Acceleration Notice void, and this Lease shall continue in full force as if Tenant had not exercised such Acceleration Option.

17.4 Termination of Unexercised Options. As of the date Tenant provides Landlord with its Acceleration Notice, any unexercised rights or options of Tenant to renew the Term of this Lease or to expand the Premises (whether expansion options, rights of first or second refusal, rights of first or second offer or other similar rights), and any outstanding Tenant Improvement Allowance not claimed and properly used by Tenant according to this Lease as of such date, shall immediately be deemed terminated and no longer available or of any further force or effect.

17.5 Conditions. Tenant may only exercise its Acceleration Option and an exercise thereof shall only be effective if at the time of Tenant's exercise of the Acceleration Option, this Lease is in full force and no event or circumstance exists which, with the giving of notice or the passage of time, or both, could constitute a default by Tenant under this Lease, and, inasmuch as the Acceleration Option is intended only for the original Tenant named in this Lease, the entire Premises are then occupied by the original Tenant herein or a Permitted Transferee or a Transferee to whom this Lease has been assigned with Landlord's consent, and Tenant has not assigned this Lease other than to a Permitted Transferee or a

Transferee to whom this Lease has been assigned with Landlord's consent nor is any portion of the Premises sublet. Without limitation of the foregoing, no assignee (other than a Permitted Transferee or a Transferee to whom this Lease has been assigned with Landlord's consent) or sublessee shall be entitled to exercise the Acceleration Option, and no exercise of the Acceleration Option by the original Tenant named herein shall be effective, if Tenant assigns this Lease or subleases any portion of the Premises prior to the Accelerated Termination Date other than to a Permitted Transferee or a Transferee to whom this Lease has been assigned with Landlord's consent.