ARTICLES

Enforceability of Cotenancy Clauses: Remedy or Penalty?

By Howard Jeruchimowitz

Cotenancy clauses are common in retail leases. Their purpose is to provide tenants with a remedy in the event that a cotenancy condition is not met, such as when a specified major tenant in a shopping center fails to open or a certain percentage of occupancy is not achieved at the remainder of the shopping center. Remedies for a cotenancy failure range from being released from the obligation to open, to rent abatement, or lease termination. Recently, there have been a number of cases in which landlords have challenged remedies for alleged cotenancy failures as unenforceable penalties. Often, the challenged leases are antiquated and negotiated in a vacuum long before tenants make use of the remedies or landlords understand the impact they might have on the shopping center.

In a case of first impression, the California Court of Appeal ruled on the enforceability of a cotenancy 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 cotenancy clause was not unconscionable, (2) the termination remedy for failure of the cotenancy 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.

Although courts in other states have yet to second-guess cotenancy provisions and generally find them enforceable, the *Grand Prospect* case has opened the door, at least in California, to questioning whether the remedies in a cotenancy provision are unenforceable penalties. Even so, the reality is that cases fighting over cotenancy clauses are fact-specific and limited to circumstances where the landlord can show that the remedy bears no relationship to the facts or that the clause was not negotiated between the parties but rather was one of adhesion. Therefore, landlords and tenants should pay attention to and carefully negotiate such provisions in their leases because courts will most likely enforce them as written.

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Overview of Cotenancy Clauses

Grand Prospect provides a good overview of California-specific cotenancy requirements. As the court outlined, cotenancy requirements are included in retail leases for the benefit of the tenant.

They usually require other stores in the shopping center to be occupied by currently operating businesses. And they typically have one of two purposes. Opening cotenancy clauses require that a critical mass of key tenants or occupants has opened or will open when the tenant opens at the shopping center before the tenant is obligated to open or commence paying minimum rent. Operating cotenancy clauses condition the tenant's obligation to continue to conduct business or pay minimum rent on the active operation of certain named tenants or a set level of occupancy within the shopping center during the term of the lease after the tenant has opened.

Cotenancy requirements are negotiated between the landlord and tenant and vary with the parties and the circumstances related to that particular shopping center. The major points usually include: (1) the specific named co-tenant and level of occupancy required, (2) the landlord's right to cure a failure to meet a cotenancy requirement, and (3) the tenant's remedies for a cotenancy failure. And such remedies might include: (1) the right to delay the opening of the tenant's store, (2) the payment of alternative rent, (3) the termination of the lease, or (4) a combination of these remedies. There may be further variations if the tenant's exercise of these remedies is conditioned on the absence of a tenant default, the tenant's continued operation of the business on the premises, or a limitation period to exercise the remedy.

Facts of the Cotenancy Requirement in the *Grand Prospect* Lease

Grand Prospect Partners, L.P., as the owner and operator of the Potterville Marketplace shopping center, filed a lawsuit challenging the enforceability of provisions in its lease with its tenant, Ross Dress for Less, Inc. The cotenancy provision at issue conditioned Ross's obligation to open a store and pay rent on a department store chain, Mervyn's, 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 cotenancy condition was not satisfied because Mervyn's filed for bankruptcy and did not open its store near the Potterville 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 Court's Holding in *Grand Prospect*

The trial court agreed with Grand Prospect that the rent abatement and termination under the cotenancy 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 trial court then granted Grand Prospect's attorney petition for fees and entered an amended judgment of $4,701,990.83. Ross appealed, contending

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that the cotenancy provision in the lease was neither procedurally nor substantively unconscionable and was not an unreasonable penalty.

In summarizing cotenancy conditions in leases, the California Court of Appeal noted:

> The variation in cotenancy requirements, and the remedies given to a tenant when the requirements are not met, prevents the application of a categorical rule of law regarding enforceability. For instance, there is no general principle of California law holding cotenancy provisions in a commercial retail lease can never be unconscionable. Similarly, there is no categorical rule holding cotenancy provisions are unreasonable per se and therefore unenforceable penalties. Instead, the validity of a cotenancy provision depends upon the facts and circumstances proven in a particular case.

On the basis of the facts and circumstances of the *Grand Prospect* case, the court concluded that the cotenancy 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 cotenancy provision during the negotiations did not make the lease a contract of adhesion or otherwise deprive the landlord of a meaningful choice.

As for the remedies of rent abatement and termination for failure to satisfy the cotenancy, 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 cotenancy 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 for the lease termination provision, California courts have adopted a specific rule that holds no forfeiture results from terminating a commercial lease based on the occurrence of contingencies that (a) are agreed on by sophisticated parties and (b) have no relation to any act or default of the parties. On the basis of those factors, the court disagreed with the trial court, and found that the termination provision did not create an unreasonable penalty.

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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 attorney 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 attorney fees awarded by the trial court upon remand.

Other Cases

Before *Grand Prospect,* other courts typically found cotenancy conditions and their remedies to be enforceable. For example, two federal court opinions in 2012 illustrate landlord challenges to rent remedies for cotenancy 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 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; it also 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 cotenancy 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 U.S. District Court for the Eastern District of Tennessee found that the lease entitled the tenant to pay only 4 percent of gross sales or the guaranteed minimum rent defined in the lease for a cotenancy 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 cotenancy failure. The landlord argued that the cotenancy 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 cotenancy provision, and (2) the landlord did not show any evidence of fraud or undue mistake or that the provision was unconscionable.

These two federal court cases continued the long-honored tradition of contract law of enforcing leases as written and ignoring the financial impact to the tenant seeking rent relief under it.

The Takeaways from *Grand Prospect*

Although cotenancy provisions usually are upheld, the California court with *Grand Prospect* has led, in certain factual circumstances, to the possibility of striking down remedies for failure to

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satisfy a cotenancy condition as an unenforceable penalty, particularly the remedy of rent abatement, 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 cotenant does not occupy the space or open for business. Landlords now have ammunition to make a court look twice at such provisions, particularly if the tenant has suffered no damages at all.

In *Grand Prospect*, the rent abatement provision allowed Ross to pay nothing and had no end date for Ross' right to rent abatement even if it opened and operated its store. The outcome might have been different if the rent abatement had the more traditional percentage off (like 50 percent), was tied to anticipated sales, or set a definite time. 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. In addition, the Court may have been swayed by the fact that Grand Prospect paid more than $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 cotenancy failure).

Landlords and tenants, therefore, should carefully negotiate cotenancy provisions bearing the holding in *Grand Prospect* and the relevant jurisdiction in mind. During negotiations, the parties should consider, among other factors, the amount of rent abatement, the time period the tenant can exercise the rent abatement, the cure period and type of cure for the landlord. This will maximize the likelihood that the negotiated cotenancy provision will not be challenged by the parties or will be enforced by the courts if it is.

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