

Co-Tenancy: Tied at the Hip— The Who, The What and The Why

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Co-Tenancy Clauses: A Powerful Tool

- Co-tenancy clauses can be powerful tools for both tenants and landlords.
- Tenants can ensure they are not operating alone.
- Despite potential risks, they allow Landlords to induce national retailers and anchor tenants.
- Often heavily negotiated provisions.

Poll: How often do you negotiate co-tenancy provisions in leases?

Are you negotiating them on behalf of a Tenant? Or a Landlord?

The Who and Why of Co-Tenancy Provisions

1 Retail Operators

Retail operators want the best possible shot for success when opening a new location in a shopping center. This success often hinges on the center's overall ability to attract customers.

2 Negotiating Leverage

Retail tenants with greater negotiating leverage (national and large regional credit tenants) will typically seek to include "co-tenancy" provisions in their leases.

3 New Developments

Co-tenancy provisions are particularly important when a retailer is going into a new development, where there are no or few existing retailers currently operating.

Retail Operators Want the Best Shot for Success

- Vibrant shopping centers
- Centers with high occupancy rates
- Large national or well-known anchor tenants
- Other complimentary retailers

Retailers with Greater Negotiating Leverage

- National and large regional credit tenants that are typically highly sought after by landlords
- More likely to seek co-tenancy provisions in their leases
- Particularly common when retailer is going into a new development
- Often negotiated as early as letter of intent stage

Three General Types of Co-Tenancy Provisions

1. Delivery Co-Tenancy
 2. Opening Co-Tenancy
 3. Operating Co-Tenancy
- Details will depend on negotiating leverage of the parties involved
 - Delivery and Opening – conditions prior to tenant opening (or earlier)
 - Operating or On-going – conditions must be satisfied throughout term of lease

Poll: Do you see co-tenancy provisions requiring opening co-tenancy, operating co-tenancy or both?

Delivery Co-Tenancy

- A condition precedent to tenant's acceptance of delivery of premises
- Generally, only where the retail center is not yet constructed
- “Inducement Tenants”
- Advantage is tenant's ability to terminate lease before incurring expenses

Example: Delivery Co-Tenancy Provision

“Landlord shall enter into lease agreements with _____, _____, and _____ (hereinafter referred to as the “Inducement Tenants”) to open and operate in the locations shown on Ex. B and such leases shall provide that each Inducement Tenant shall open for business in the designated premises and operate for at least one (1) day for terms commencing simultaneously or prior to the term of this lease.”

Opening Co-Tenancy

- Condition precedent to the tenant's obligation to open store and/or commence paying rent
- Typically used when shopping center is a new development or being redeveloped
- Minimum square footage threshold
- Specifically named co-tenants

Specificity is Critical

- Options for square footage requirements:
 - Total of “x” number of nation/regional tenants open and operating in “y” square feet
 - Percentage open and operating of the total gross leasable area of the center
- Who is a “national” or “regional” tenant?
- Is % GLA calculated based on site plan or what has actually been built?
- If referencing named tenant on a site plan, make sure they are shown on the site plan

Example: Opening Co-Tenancy Provision – Gross Leasable Area

“If upon the Commencement Date, _____ square feet of **[in-line tenant]** gross leasable area is not open and operating **[Alt: If upon the Commencement Date the following named tenants: tenant A (____ sq. ft.), tenant B (____sq. ft.) are not open and operating]** for retail use within the Shopping Center (the “Co-Tenancy Requirement”)....”

Language: Opening Co-Tenancy Provision – “X” Operating in “Y”

- “...not less than three Required Tenants occupying a combined total of not less than sixty thousand (60,000) square feet (excluding outlot tenants) shall be open, fully staffed, stocked, and operating within twelve (12) months...”
- “...“Required Tenant” shall mean: (i) a tenant operating a minimum of fifty (50) retail stores, under the same trade name, in at least twenty (20) states; or (ii) a tenant operating a minimum of ten (10) high quality retail stores, under the same trade name, in at least four (4) different states, of the types typically found in first-class shopping centers; provided, however, that a Required Tenant cannot be: (a) close-out retailers such as, without limitation, Big Lots, Odd Lots, and Ollies; (b) single price-point retailers such as, without limitation, Dollar Tree, Dollar Wave, and Dollar General; or (c) in violation of any Prohibited Uses or the Tenant’s Exclusive.”

Poll: Do you see opening co-tenancy requirements only in new developments or in existing projects as well?

Ongoing or Operating Co-Tenancy

- Typically runs the entire term of the lease
- Grants tenants' certain remedies if:
 - Occupancy levels are not maintained and/or
 - Key tenants leave and are not suitably replaced
- Resembles Opening Co-Tenancy Clause
 - May include “Key Tenant” or “Anchor Tenant” clauses
 - Often relies on required number of open tenants or % of GLA to remain open

Example: Operating Co-Tenancy Language

- “Tenant shall not be required to pay Minimum Rent until such time as: (i) a total of twenty-five thousand (25,000) square feet of ground space (excluding the Leased Premises) are open and being operated by other tenants in the Shopping Center (“Additional Tenants”); and (ii) at least two of the Additional Tenants each occupy not less ten thousand (10,000) square feet of ground space.”
- “If during the Term of this Lease fifty percent (50%) or more of the leasable space in the Shopping Center (excluding the Leased Premises) is vacant for a period of one hundred eighty (180) consecutive days (as applicable, a “Co-Tenancy Failure”), Tenant shall have the right upon written notice to Landlord to reduce Minimum Rent by fifty percent (50%) effective on the last day of the month in which the such notice is received until the Co-Tenancy Failure ends.”
- “Tenant shall resume payment of full Minimum Rent on the first day of the month after the Co-Tenancy Failure ends.”

Remedies for Co-Tenancy Violations

- Tenant's remedies usually fall into one of three categories: (a) delayed opening; (b) rent abatement; and (c) lease termination.

Opening Co-Tenancy Violations: Delayed Opening

- Tenant's requirement to open is contingent upon the co-tenancy condition being satisfied by the planned opening date
- Allows the tenant to delay the opening and/or rent commencement date
- Could cause a chain reaction of co-tenancy failures in a large development
- Alternatively—tie co-tenancy satisfaction to evidence that a tenant is preparing to open

Rent Abatement

- Tenant may elect to open or remain open, but its obligation to pay rent will be reduced until the co-tenancy requirement is satisfied
 - Tenant still required to pay additional rent (i.e. contributions to taxes, insurance, and common area expenses)
- Flexible landlord options:
 - Provide a window for satisfaction of the co-tenancy requirement before rent is reduced
 - Negotiate a sunset on the reduced rent

Lease Termination

- Used in delivery, opening and operating co-tenancy situations
- Terminating tenant will usually still experience some loss (e.g. architect fees and permitting costs)
 - Negotiate landlord's reimbursement of tenant's out-of-pocket costs
- Landlords should negotiate a cure period
- Go-dark period followed by right to terminate
 - May include abatement of rent
 - Landlord should negotiate a recapture right
- Reimbursement of tenant improvement allowance?

Conditions to Exercise of Tenant Remedies

- Additional Landlord positions that may prove helpful

Poll: What are some conditions a landlord should require for a tenant to exercise its remedies?

Conditions on Tenant Remedies

1 Tenant in Good Standing

Tenant must not be in default under the lease in order to exercise co-tenancy remedies.

2 Tenant Open and Operating

For ongoing co-tenancy violations, tenant must be open and operating in the space to claim remedies.

3 Remedies Non-Transferable

Co-tenancy remedies may be limited to the original tenant, not transferable to assignees or subtenants.

4 Proof of Sales Impact

Tenant may need to prove diminished sales during the co-tenancy violation period.

Replacement Tenant Considerations

Size of Premises

Landlords should define whether a replacement tenant must lease all or just a percentage (e.g. 70-90%) of the original co-tenant's space.

Number of Locations

Replacement tenants may need to have a certain number of regional or national locations to qualify.

Specific Use

The replacement tenant's use may need to match the original co-tenant (e.g. if replacing a grocery store).

Co-Tenancy as a Condition, Not a Default

- Co-tenancy provisions should be drafted and treated as agreed-upon contract conditions—*not* as covenants or promises constituting a lease default or breach
- If a condition is not met, the tenant has the options and rights provided in the lease contract
- Provision should expressly limit tenant's rights to those stated in the provision

Courts' View of Enforceability of Co-Tenancy Provisions

Grand Prospect Partners, LP v. Ross Dress for Less, Inc. (Cal. App. 5th Dist. 2015)

- Co-tenancy provision allowed Ross to not pay rent because of anchor vacancy, regardless of Ross having opened for business
- Ross admitted it was not damaged by the failure of the co-tenancy provision
- Court held the rent abatement to be an unenforceable penalty
 - Forfeiture was disproportional to harm anticipated by a breach

JJD-HOV Elk Grove, LLC v. Jo-Ann Stores, LLC (Cal. App. 3rd Dist. 2022)

- Declined to follow *Grand Prospect*
- Rejected “penalty” argument
- Upheld co-tenancy clause—emphasizing “general rule that courts should enforce contracts as written”
- Distinguishing facts:
 - “Substitute” rent vs complete abatement
- Court held co-tenancy clause simply established a “condition precedent”

What lease language has been the subject of disputes over co-tenancy clauses?

- A. “Equivalent” replacement tenant
- B. “National” retailer
- C. “Regional” retailer
- D. “Anchor” tenant
- E. “Key” tenant

Federal Courts Have Upheld Co-Tenancy Clauses

- *Sun Valley, Ltd. v. Galyan's Trading Co., LLC*, No.13-13642, 2014 U.S. Dist. LEXIS 34103 (E.D. Mich. Mar. 17, 2014)
 - Lease did not expressly contemplate “equivalent” replacement tenant
- *Staples Office Superstore E., Inc. v. Flushing Town Ctr. III, LP*, 933 N.Y.S.2d 732 (2011)
 - Debating whether BJ's Wholesale Club was a “National retailer”

Importance of Clear Lease Language

Equivalent Replacement

Leases should clearly define what constitutes an "equivalent" replacement tenant if an original co-tenant closes.

Regional vs National

Carefully define criteria like "regional" and "national" tenants to avoid disputes over replacement tenants.

Poll: Has anyone had experience litigating a co-tenancy provision?

Additional Clauses for Landlord Consideration

Continuous Operating and Recapture Rights

- National, credit tenants often demand strong co-tenancy provisions but are unwilling to agree to continuous operating clauses
- Landlords should ensure other leases have enforceable operating covenants
- Alternatively, landlords should negotiate for strong recapture rights
 - Prevent chain reaction of co-tenancy failures by quickly finding an “equivalent” replacement tenant

Percentage Rent Clauses

- Landlords should ensure that percentage rents are not affected by the failure of a co-tenancy condition
 - Clarify that during any reduced rent period tenant is obligated to pay full percentage rent
- If percentage of sales exceed “break point” —tenant should expressly exclude sales occurring during reduced rent period from calculation of the percentage rent payable when there is no co-tenancy violation
- Landlord should stipulate that break point is reduced proportionally during reduced rent period

Excused Closures

- The lease should specify that closures due to the following do not trigger co-tenancy violations:
 - Casualty events
 - Force majeure events
 - Condemnation
 - Remodeling periods
- Should establish time limits for rebuild after casualty or condemnation
- Should specify tenant's timeframe for re-fixturing and re-opening premises

Opening Covenant

- Many national tenants will not agree to a continuous operation clause
- However, an opening requirement is common:
 - “Tenant will open for at least one (1) day within the premises within X days of delivery date”
- Tenant should be mindful that terms of co-tenancy requirement and opening covenant are not conflicting
 - If tenant has right to delay opening, then obligation to open should be conditioned on landlord’s satisfaction of co-tenancy requirement

Negotiating Co-Tenancy from Landlord's Perspective

Understand Center Size

Consider the size and configuration of the center when negotiating co-tenancy terms.

Review Existing Leases

Understand the terms of leases already in effect that could impact timing.

Anticipate Delays

Factor in potential delays that could affect development and construction timelines.

Landlord Perspective on Co-Tenancy Risks

1 Significant Remedies

Tenant remedies like rent reduction or termination are very impactful for landlords.

2 Lack of Control

Landlords must guarantee conditions they don't fully control when granting co-tenancy rights.

3 Interplay of Leases

One tenant's co-tenancy violation can trigger issues across multiple leases in a project.

Tenant Remedies are Significant

- From a landlord's perspective, the remedies available to the tenant for a co-tenancy breach are significant, often including:
 - Reduction in rent
 - Termination of the lease
- Co-tenancy provisions essentially require the landlord to make guarantees about conditions outside of their direct control.

Mitigating Co-Tenancy Risks

Tenant Improvement Allowance Considerations

If the landlord provided an upfront tenant improvement allowance, the lease should allow the landlord to:

- Require repayment of some/all of the allowance if tenant terminates for co-tenancy violation
- Potentially increase the repayment amount over time

This helps protect the landlord's investment in the event of an early termination.

Recapture Rights

If a tenant has a go-dark right due to co-tenancy, landlords should negotiate for a recapture right, allowing them to:

- Regain possession of the premises after a set period
- Re-tenant the space before tenant can reopen

This prevents a long-term dark storefront and lost rental income.

Negotiating the Letter of Intent

Co-tenancy provisions are often initially negotiated during the letter of intent stage, before the full lease is drafted. Key aspects to address upfront:

- General co-tenancy structure (delivery, opening, operating)
- Named co-tenancy requirements
- Potential remedies for violations

Getting alignment early can prevent protracted lease negotiations later.

Balancing Negotiation Leverage

The specific details of co-tenancy provisions will depend heavily on the relative negotiating leverage of landlord and tenant, with national credit tenants typically having more leverage to dictate terms.

Landlords should seek to negotiate:

- Reasonable criteria for named co-tenants
- Limits on rent reduction periods
- Cure periods before termination rights

Continuous Operation Considerations

Tenant Demands

National credit tenants often demand strong co-tenancy provisions but resist continuous operation clauses.

Landlord Options

Landlords should negotiate for either enforceable operating covenants in other leases or strong recapture rights.

Replacement Tenants

The ability to quickly backfill vacant spaces with new or "equivalent" tenants is critical.