



Co-Tenancy Breaches and Remedies: Drafting Guidance for Landlords and Tenants After Grand Prospect Partners

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Last month, the California Fifth Appellate Court issued a ruling concerning the enforceability of co-tenancy provisions in commercial leases. *Grand Prospect Partners, L.P. v. Ross Dress for Less, Inc., et al.* (January 12, 2015, F067327)___Cal.4th___[2015 DJDAR 409] ("Grand Prospect") was the first time such enforceability had been discussed in a case published by a California appellate court. The facts of the case, along with its ruling, provide important guidance to both landlords and tenants on the breach of co-tenancy provisions and available remedies post-breach.

Co-Tenancy Provisions in Commercial Leases

Co-Tenancy provisions are commonly requested by tenants in shopping centers to ensure that a certain percentage of the center is occupied by other tenants or that specific tenants are present in a center. By requiring a specific occupancy level, or the presence of particular tenants, the tenant is ensuring that there will be sufficient foot traffic at its location in order to drive sales. For instance, in a regional mall, a smaller retailer may request that the anchor store spaces be occupied by certain larger national retailers. If the spaces cease to be filled by national retailers, the co-tenancy provisions will be breached and the smaller retailer may be entitled to the remedies specified in the lease. There are two general types of co-tenancy clauses: opening co-tenancy requirements and operating co-tenancy requirements. Opening co-tenancy requirements are conditions that must be met before a tenant is obligated to open or begin paying rent. Operating co-tenancy contain conditions that must be met during the term of the lease, and in the event the conditions fail, the tenant's obligation to continue to operate its business or pay rent may be terminated or reduced depending on the terms of the lease. While co-tenancy provisions vary depending on the circumstances, they generally provide that specific conditions must be met, the tenant's remedies in the event of the co-tenancy requirements are not met, and the landlord's right to cure in the event of a co-

tenancy failure.

Grand Prospect Partners, L.P. v. Ross Dress for Less, Inc., et al.

In *Grand Prospect*, the landlord began negotiating a lease with Ross Dress for Less, Inc. ("Ross") in 2005 to locate in the Porterville Marketplace in Porterville, California. A final lease was executed in April 2008. The terms of the lease contained a co-tenancy provision that required the Mervyn's located in the shopping center to be open and operating as of the Ross' commencement date. If the co-tenancy condition was not met, Ross was not obligated to pay rent, and the landlord would have 12 months to cure, after which Ross would have the right to terminate the lease. The lease additionally provided that the landlord would perform certain construction work, which was completed in July 2008; however Ross was not obligated to take delivery of the premises until early 2009. That summer, Mervyn's filed for bankruptcy and its store in the shopping center closed in December 2008. Due to the failure of the opening co-tenancy provision, Ross never took possession, did not open its store, and, per the terms of the co-tenancy clause, did not pay rent and eventually terminated the lease in 2010 at end of the landlord's 12-month cure period. The landlord sued, arguing the co-tenancy provisions were unenforceable, and that it was entitled to damages for unpaid rent, future rent, and expenditures on tenant improvements.

At trial, the landlord argued that the co-tenancy provisions were unenforceable as the rent abatement and termination clauses were unconscionable, or, in the alternative, were an unreasonable penalty. The lower court agreed and found the co-tenancy provisions unenforceable and struck the provisions from the lease. The jury then found Ross liable for all of the claimed damages, amounting to \$4,701,990.83, including landlord's attorney's fees. Ross appealed.

The court of appeal partially overturned the trial court's verdict, finding the following:

- The co-tenancy provisions were not unconscionable. The parties were both sophisticated and had spent considerable time – from 2005-2008 – negotiating the letter of intent and final lease. Additionally, there were no facts to support that the landlord was under any sort of time or economic pressure that would have induced it to sign a less than favorable lease.
- The rent abatement provision was an invalid penalty against the landlord. To reach this determination, the court compared the value of the property forfeited by the landlord to the range of harm suffered by Ross. Here, the court found that the landlord had lost its right to possess the property, along with the rent, while Ross, as it had not even opened or operated its store, could not demonstrate it suffered any harm by the failure of the co-tenancy conditions. Thus, the court ruled the rent abatement provision was an invalid penalty and was not enforceable.
- The court found that the termination provision was enforceable against the landlord, as it did not cause a forfeiture. Here, the court, looking to prior case law, evaluated the clause to determine if it was based upon contingencies agreed to by sophisticated parties, and that such contingencies had no relation to any act or default by the parties. The court found that there was no forfeiture as the parties were sophisticated, and had agreed to the co-tenancy conditions, and neither party had the right to control whether Mervyn's continued to operate in the shopping center.

Ultimately, the appeal court found that Ross was only liable for the payment of rent until the date it terminated the lease and reduced the landlord's award to \$672,100.

Important Lessons for Landlords and Tenants

While the outcome of the case heavily relied upon the specific facts and circumstances surrounding the lease in question, and further negotiation was unlikely to change the relevant lease terms, both landlords and tenants can take away important tips for drafting co-tenancy provisions, including:

- Tenants should include limits in their rent abatement provisions. While tenants may prefer a complete abatement of rent for an unlimited duration in the event the co-tenancy conditions fail, such provisions may be deemed invalid penalties against the landlord. Prudent tenants should include limitations on rent abatement that they believe, based on information available at the time of lease execution, are reasonably related to tenant's expected damages in the event of a breach. For instance, a court may look more favorably upon a provision that reverts to a percentage rent because the tenant will only pay rent to the extent it meets anticipated sales targets and is time limited.
- Co-Tenancy provisions should contain reasonable cure rights for the landlord. This helps both parties as it gives the landlord the ability to remedy a failed condition to resume the full payment of rent, and it also increases the chances that the tenant's co-tenancy provision will be upheld by the court.
- In *Grand Prospect*, the landlord did not own the Mervyn's parcel, but still permitted a co-tenancy provision based upon its occupancy. This lack of control of the parcel was problematic as it severely limited the landlord's ability to cure in the allotted 12-month period since the landlord had to purchase the Mervyn's property and locate new tenants that would be acceptable substitutes to Ross. Landlords should only permit co-tenancy provisions on properties owned and controlled by the landlord. Additionally, landlords should be careful to draft cure provisions that allow the landlord to replace specified co-tenants with a broad range of retailers to increase their ability to cure in the allotted time.
- Landlords need to be cautious about timing. In *Grand Prospect*, the landlord was required to improve the property before Ross was to take possession. The landlord finished the improvements shortly after the lease was signed, but Ross was not required to take possession until 7 months later. If the lease had required Ross to take possession within a reasonable time after the improvements were complete (such as 30 days), the co-tenancy provision would not have failed, as Mervyn's was still operating at that time.

Conclusion

Determining the enforceability of co-tenancy provisions is very fact specific, and the lack of court rulings on the topic in California can make it difficult for landlords and tenants to craft valid provisions. However, *Grand Prospect* provides some guidance in drafting fair provisions that both parties can agree upon.

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