

# Top Ten Issues in Co-Tenancy Provisions in Retail Leases

By Matthew P. Seeberger<sup>1</sup>

As many real estate professionals know, co-tenancy is one of the more heavily negotiated provisions in a retail lease. A co-tenancy provision permits a tenant to exercise remedies if certain conditions are not met with respect to the shopping center in which it is located. As discussed below, co-tenancy provisions are typically tied to the presence of certain “key” tenants or an occupancy threshold based on a percentage or specified amount of tenants or a square footage in a center being open. Tenants want co-tenancy provisions, which may relieve them from being obligated to open, pay full rent or operate in a shopping center that is not fully occupied, providing remedies in the event that the performance of the center is not what the tenant was anticipating. Landlords dislike co-tenancy provisions because (i) they cannot control the actions of other tenants or occupants in the shopping center, (ii) they feel that a certain amount of vacancy is unavoidable, and (iii) their rent stream from the shopping center can be severely impacted. This article will briefly discuss the top ten issues in co-tenancy provisions in retail leases.

1. **Leverage.** Whether or not a tenant is successful in obtaining a co-tenancy provision is largely dependent on the negotiating leverage that tenant possesses. National and large regional credit tenants are generally highly sought after by landlords because of their name recognition, ability to pay higher rents, and staying power, and “hot” tenants are desirable because they have drawing power and can increase the cachet and prestige of a shopping center. Such tenants usually are in a

better position to obtain co-tenancy protection than smaller regional, lesser credit and shop (“mom and pop”) tenants.

2. **Opening Co-Tenancy.** Co-tenancy provisions fall into two categories. The first is an opening co-tenancy, which provides that a tenant need not open its store at full rent unless and until certain other stores, or a certain amount of stores, in the shopping center are open. An opening co-tenancy is usually found in the context of a shopping center in development, which may still be in the entitlement, lease-up or construction phase, particularly in an outlying area where and projections of population growth and income levels have yet to be realized, in which case a tenant will want assurances that the shopping center will be built, occupied and open before it is required to invest its resources in opening a new store. However, an opening co-tenancy may also be found in an existing shopping center that is being renovated or repositioned.

3. **Operating Co-Tenancy.** The second category of co-tenancy provisions is an operating co-tenancy, which provides that once a tenant has opened and is operating, it will be obligated to stay open at full rent only if certain other stores, or a certain amount of stores, are also operating. An operating co-tenancy is not limited to any particular type of shopping center, as no matter where the shopping center is located or how old or new it is, a tenant will not want to be required to stay open in a shopping center where other stores are closing and the synergy of a healthy center is declining.

4. **Key Tenants.** Co-tenancies usually are geared to certain “key” tenants, so-called because they are viewed by the tenant seeking co-tenancy protection as “key” to the success of the shopping center and/or the particular tenant. For example, a tenant generally will not want to be obligated to open or keep operating its store at full rent unless the anchor store in the shopping center, usually a department store in a regional mall or a grocery store in a neighborhood shopping center, is also open and operating. Where there is no true anchor store – *i.e.*, no store is dominantly larger than the other sizable stores (such as in a power shopping center) – a tenant may not want to be open or operate at full rent unless a certain number of mini-major (roughly 15,000 to 30,000 square feet) stores are also open and operating. Another benchmark that is often used is that a certain percentage of or number of stores in the shopping center be open or operating before that tenant has to open or keep operating at full rent. Sometimes, a tenant with significant negotiating power will require that a combination of two or even all three of the above be satisfied before it must open or keep open its store at full rent – *e.g.*, a tenant may require that one of two anchor stores, four of seven mini-major stores, and 75% of the shop spaces, or at least 100,000 square feet of the shop space in the shopping center, be open before that tenant is required to open its store and begin operating, or, if already operating, to keep operating at full rent.

5. **Replacement Tenants.** Tenants seeking co-tenancy protection typically specify the name of the anchor and/or mini-major store(s) that must be open and operating, as landlords usually try to obtain commitments from anchors and mini-majors before committing to develop a shopping center, and the tenant is relying on the existence of that (or those) particular tenant(s). While a landlord may agree to a co-

tenancy provision, it will want to avoid being locked into the specifically listed stores, because landlords are only too aware of the fickleness of the retail sector – a retailer that is “hot” or national or regional in scope and/or with excellent credit might be declining, or even land in bankruptcy court, in a few years. Therefore, landlords will typically require that a co-tenancy provision is satisfied if a “replacement” tenant is open and operating in lieu of a key tenant that is no longer operating. This is usually acceptable to tenants if the replacement tenant is comparable to the named or departing tenant. For example, a landlord may insist that a replacement tenant which occupies most of the vacated space, has a similar (*i.e.*, soft goods or electronics) business, and is comparable in creditworthiness to the departing tenant be deemed to satisfy a co-tenancy provision.

6.     **Conditions.** Before a tenant can invoke a remedy under a co-tenancy provision, a landlord will want the tenant to satisfy certain conditions. Foremost is that the tenant is not then in default under the lease, but such conditions may also include that the tenant is itself operating at the time of a violation of the co-tenancy provision, and that the right to invoke the remedy is personal to the original tenant that signed the lease. A landlord may also require that the tenant show a drop in sales during the co-tenancy violation period as compared to the period prior to the violation. Finally, a landlord will want to make sure that if the tenant invokes a co-tenancy provision, the remedy elected by the tenant for such co-tenancy violation is the tenant’s sole remedy for such violation. A landlord does not want to be in a situation where the tenant obtains the benefit of a co-tenancy violation remedy, such as rent abatement or termination, only to have the tenant then sue for other damages.

7. **Cure.** A landlord will also want to have the right to cure a co-tenancy violation before the tenant can invoke any remedies, as the violation might occur with little or no warning, such as a bankruptcy filing. The cure right almost always involves the right to try to obtain replacement tenants for the key tenants, or, in the case of an occupancy threshold, to try to fill the vacant space. Therefore, most landlords will agree to a co-tenancy right only if the violation continues for a significant period of time, with the amount of time depending on the types of remedy that the tenant may elect.

8. **Remedies.** A tenant's remedies for a co-tenancy violation fall into three categories. The first such remedy is rent abatement, where if a co-tenancy violation is not cured within the stated time period, the tenant has the right to pay a lesser rent for so long as the co-tenancy violation exists. The lesser rent is typically based on either a percentage of the fixed annual rent (usually 50%) or percentage rent only during the violation period. The second remedy for a co-tenancy violation is termination of the lease, but as this is an extreme remedy, landlords are loathe to grant it unless the co-tenancy violation continues for an extended period of time – at least six months, often a year, and even longer if the space is particularly large (such as a space occupied by Target, Home Depot or Wal-Mart). An operating co-tenancy provision will usually allow for rent abatement and termination (because rent abatement is not as drastic, a landlord will often permit a tenant to invoke that remedy sooner than the termination remedy, sometimes as soon as the violation occurs, but usually after a relatively short period of time [90 days is typical]) The third remedy for a co-tenancy violation only arises if there is an opening co-tenancy violation, and allows the tenant to delay the opening and/or

rent commencement date (although most tenants will also want to have the right to open but with rent abatement as set forth above).

9. **Return to Full Rent; Recapture.** If a tenant elects rent abatement, the landlord will not want the tenant to be able to take advantage of the substitute rent provision for the remainder of the lease term. In such an instance, a landlord will typically require that if the co-tenancy violation is not cured within a certain period of time (typically one year) and the tenant has not terminated the lease within that time, then the tenant will have to return to paying full rent. The obligation to return to paying full rent is based on the theory that if the tenant is remaining in the shopping center despite the co-tenancy violation it must believe that its store is doing well enough to warrant continuing at full rent. If the tenant does not want to return to full rent, then the landlord will usually insist on the right to recapture the premises.

10. **Reimbursement.** If either party terminates the lease due to a co-tenancy violation, the tenant will want to be reimbursed for its unamortized leasehold improvements (typically amortized on a straight-line basis over the initial term), since the termination was not due to an event within the tenant's control. However, reimbursement should only apply during the initial term of the lease, as that is the length of time on which the tenant based its original decision to enter into the lease.

In summary, while landlords may use whatever bargaining power they possess to avoid granting a co-tenancy provision in a retail lease, the circumstances may dictate that a deal will not get done without one. In such a case, the negotiation of the co-

tenancy provision will raise several issues that both the landlord and tenant will need to address to arrive at a compromise that satisfies both parties.

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