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Legal Update: Enforceability of Cotenancy Clauses in Retail Leases

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Related Practices: **Commercial Lease Disputes**, **Leasing**

In a case of first impression, the California Court of Appeal recently weighed in on the enforceability of cotenancy clauses in retail leases. A cotenancy clause typically provides that if a specified major tenant or a certain defined level of occupancy is not reached in a retail project, then the tenant is not obligated to open and, typically, is granted a termination right.

SUMMARY

In *Grand Prospect Partners, L.P. v. Ross Dress For Less, Inc.,* ___Cal.App.4th___, 2015 WL 161160 (5th Dist. 2014) the Court considered a challenge to such a clause by a commercial landlord, and held that (1) the cotenancy clause was not unconscionable, and (2) a termination remedy for failure of a cotenancy condition in a retail lease was enforceable because the parties were sophisticated and the condition triggering the right to terminate was not under the control of either party, but (3) the rent abatement remedy for failure of a cotenancy condition was an unenforceable penalty because the rent that the landlord forfeited had no reasonable relationship to the anticipated harm to the tenant.

ACTS

The tenant in this case, Ross Dress For Less, Inc. ("Ross"), entered into a lease in a shopping center with a sophisticated landlord. The lease contained a negotiated cotenancy clause which provided that Ross had no obligation to open its store if certain other tenants were also not open, including Mervyn's. If these conditions were not met for a period of 12 months, then Ross could terminate the lease. In addition, during the period that the conditions were not met, Ross had no obligation to pay rent, whether Ross was open and operating or not. Mervyn's went bankrupt and failed to open its store, and Ross terminated the lease after 12 months. Significantly to the Court, the landlord did not own the Mervyn's parcel.

HOLDING

The Court rejected the landlord's contention that the cotenancy provision was unconscionable. The parties were sophisticated and engaged in real negotiations concerning the terms of the lease, so the clause could not be considered adhesionary or so unreasonable as to "shock the conscience".

Further, the Court found that the termination remedy, as such, did not create a forfeiture, and therefore, was not an unenforceable penalty under applicable California law. The conditions triggering the termination right were (1) agreed upon by sophisticated parties, and (2) their occurrence had no relation to any act or default of the parties because, when the Lease was made, neither Ross nor the Landlord could control whether Mervyn's opened a store in the shopping center.

However, the Court held that the rent abatement remedy was an unenforceable penalty and therefore an invalid liquidated damages provision. The Court found that California law required an analysis of whether the value of the money or property forfeited or transferred to the party protected by the provision bears any reasonable relationship to the range of harm anticipated to be caused to that party by the failure of the provision's requirements. Here, the trial court found that Ross actually did not anticipate any harm from the failure of the opening of Mervyn's. Therefore, the Court held that there was no reasonable relationship between the value of the property forfeited by the Landlord (i.e., $39,500 monthly rent) and the anticipated harm to Ross (i.e., $0).

FURTHER CONSIDERATIONS

It is worth noting that the Court emphasized that its holding was fact specific, leaving open the possibility for a different outcome if, for instance, it could be proven that the tenant would anticipate harm from the failure of the cotenancy condition, or if the landlord owned the property of the required cotenant and therefore could have cured the cotenancy condition. Further, the Court may have been influenced by the drafting of the cotenancy clause, which did not provide an end date to Ross' right to rent abatement, and such abatement could have arguably continued during the entire term even if Ross opened and operated, producing a Draconian result.

Given the popularity of cotenancy clauses in retail leases both in California and nationwide, this case will undoubtedly engender a heated debate, and perhaps further appellate action. In the meantime, both landlords and tenants should carefully examine cotenancy clauses in their leases, and, where pertinent, revise such clauses (especially with respect to the tenant's ability to pay no rent until the cotenancy condition is satisfied) in light of the holding.

For more information regarding this legal update, please contact Amanda Alden at amanda.alden@msrlegal.com or 925-935-9400.

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