



RETAIL LAW STRATEGIST

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NET-working From the ICSC Library

By Michael Tubridy

Lifestyle Centers and Condominium Declarations

In metropolitan areas, where land might not be either readily available or inexpensive, the demand for larger lifestyle centers is creating unprecedented development and leasing challenges, particularly as developers build up rather than build out, according to David J. Rabinowitz, co-chair of the retail practice group in the New York City office of Sutherland Asbill & Brennan LLP.

In "Urban Lifestyle Centers: Challenges and Solutions for a Growing Trend" (*Shopping Center Business*, May 2008; <http://www.shoppingcenterbusiness.com/articles/MAY08/story42.shtml>), Rabinowitz points out that the biggest of these

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Keeping Co-Tenancy From Becoming No Tenancy

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A tenant's worst nightmare is being the last store to remain open in a shopping center. This concern is becoming more immediate today, as tenants hear of retail chain consolidations and multiple store closings in daily news reports. To avoid this, most national tenants now ask for a lease "co-tenancy" provision, which permits them to "go dark," to reduce the rent payment or even to terminate if the shopping center's anchor stores or many of the center's small in-line stores close. However, a landlord must be very careful in drafting this provision to avoid its own nightmare—tenant closings that lead to an empty shopping center.

A tenant may initially ask for language stating that if any anchor tenants close or if less than a certain percentage (perhaps 70 percent or 80 percent) of the small tenant spaces are open, then the tenant has certain rights: e.g., to go dark, reduce its rent or terminate the lease until the required occupancy levels are restored. This seems simple enough. However, the landlord needs to consider a number of issues and then craft a co-tenancy provision that will satisfy the tenant, yet give it enough time to put new tenants in closed spaces.

The Amount of Closed Stores That Will Trigger a Co-Tenancy Violation

Initially, the landlord should address the number of anchor tenants or in-line tenants that must be closed before the tenant may exercise co-tenancy rights.

The landlord should be realistic about the number and type of anchors in the center and which ones are most likely to close by reason of the end of their terms or the weakness of their business. For example, if the landlord has four anchors and two of them are near the end of their terms, then he will not want the tenant to have reduced rent or the right to close as long as at least two anchors are open. If there are two or three anchors, then the landlord may fight to restrict the tenant's co-tenancy rights to the closing of all but one. If there is only one anchor, then the landlord will need to lengthen the duration of the closing that will violate the co-tenancy clause and focus on other provisions that will reduce his risk.

The amount of in-line space that will be included in the minimum percentage of open stores should also be viewed in light of the actual layout of the shopping center. Out-lots should be excluded unless the foot traffic from them is important to the tenant's business. Similarly, in most cases, temporary spaces such as kiosk areas should be excluded. If the shopping center has

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three stories and the tenant's space is not on the third floor, then the landlord should be able to include only the first two floors in the space that must be leased. In a lifestyle center or mixed-use development, spaces that might not be used for retail should be excluded. If the development is very large, the landlord may try to satisfy the tenant's concerns by including only the rentable retail area that is most important to the tenant's business plan. If the tenant requesting the co-tenancy clause is not a food court tenant, then the landlord may wish to eliminate food court space from consideration, unless the landlord believes that that space is more likely to be tenanted than the non-food court space.

Also, of course, the landlord should negotiate a percentage amount or a square footage of in-line space that he is confident will remain open, even if the largest of his in-line tenants closes.

The Duration of the Closings That Will Result in a Co-Tenancy Violation

The lease should stipulate that the tenant cannot exercise the landlord's co-tenancy remedies unless the closings last for a substantial period. This will give the landlord a chance to exercise remedies against the closed tenant or to replace that tenant with a new tenant. Most tenants recognize that a closing may be temporary—and most tenants agree that they will not have co-tenancy rights unless the closings that trigger those rights last for a few months.

Most tenants will also agree that specified types of closings will not trigger a co-tenancy violation. A closing for remodeling will generally not trigger a co-tenancy violation since it will ultimately benefit the entire center. However, an in-line tenant requesting the co-tenancy provision is likely to limit the duration for remodeling to a couple

of weeks; an anchor tenant might limit it to one or two months.

The landlord should also exclude store closings caused by a fire or other casualty. The tenant negotiating the co-tenancy provision may ask that a casualty closing be excluded only for the minimum period necessary for repairs and re-opening. In that case, the landlord would be best-served by providing that the closing may extend for an unspecified reasonable period so long as the repairs commence promptly

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and are prosecuted diligently. If the tenant insists on more specificity, the landlord may be able to evaluate the possible casualties (and his loss of rents insurance) and decide on an estimated repair period. Also, the parties should recognize that, at some point, a casualty will trigger the Damage and Destruction provisions of the lease, which may permit both parties to terminate if the damage encompasses most of the shopping center.

The landlord should also include a provision that extends the co-tenancy trigger period for a reasonable time after he has signed a *bona fide* lease with a replacement tenant or tenants—a time that will permit the new tenant to build out and open for business.

Addressing Tenant Requirements for a Specific Type of Replacement Tenant

As a rule, national tenants like to be situated in shopping centers with other national tenants. More specifically, some types of retail tenants like to be situated in shopping centers with other tenants selling the category of merchandise to the same category of consumer. For this reason, some tenants ask that the lease state that a potential co-tenancy violation can be satisfied only by a lease to a national or specific type of tenant. The tenant may even name other retail brands that it wants to be placed in empty spaces.

This sort of limitation is, of course, very dangerous for a landlord. The landlord should not name specific replacement tenants; nor should the tenant insist on this, since a store brand that is very desirable one year may not be desirable the next year. If the landlord is willing to agree to restrict its permitted replacement tenants, then it should keep the descriptions as general as possible.

For example, if a tenant asks that national tenants be replaced only by other national tenants, the landlord may negotiate a statement that this requirement will be satisfied by a regional tenant or a tenant with a few other locations, even if both of them are in the same area. In any event, the landlord should clarify that this "national tenant" requirement will be satisfied by a tenant that is either affiliated with, or operating under the trade name of, a tenant with many locations. This will permit the landlord to lease to a national tenant's new concept entity or its single-state affiliate.

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In the case of an anchor replacement tenant, the landlord should try to avoid being required to fill a large anchor tenant space with a single tenant. The landlord should consider whether to break up the space into two or more stores or to reconfigure it in another manner—and should negotiate for this right.

The Tenant's Remedies for a Co-Tenancy Violation

Unfortunately, a landlord may be faced with a situation in which a co-tenancy provision is triggered by the closing of too many anchors or in-line tenants. Exercising remedies against a closed tenant can take quite a bit of time; and, in today's market, finding new tenants can be difficult. Even if the center is very desirable and the market is active, negotiating the lease terms and then the lease can be a lengthy process. Most tenants will insist that they do not want to operate in a partially closed shopping center for any material period without some relief. The landlord should be able to structure the tenant's remedies to coordinate or blend with the tenant's concern that it not operate at a loss; likewise, the landlord must keep a critical mass of the existing tenants open for a sufficient time to attract and install new tenants, even in a slow market.

Fortunately, not all tenant remedies for co-tenancy violations are devastating to the ultimate viability of the shopping center. Permitting the tenant to reduce its rent if it is harmed economically by a co-tenancy violation is the best way to harmonize the tenant's desire to avoid operating at a loss with the landlord's desire to keep its remaining tenants open and operating. The landlord may be able to persuade the tenant that its rent should be reduced only to the extent that its sales have

suffered during the co-tenancy violation. This structure permits the landlord to achieve full rents if the tenant's sales are not adversely affected. Instead, many tenants will ask that the rent be reduced to a percentage of sales or, if they have a strong bargaining position, to the lesser of a percentage of sales or their fixed base rent, which may also be reduced.

If the tenant is paying a reduced rent, and if the co-tenancy violation lasts for a significant period, then the landlord should have the opportunity to put a new tenant paying full rent in the space; or, the landlord may even redevelop, re-position and re-tenant the center as a whole. It is, therefore, wise for a landlord to include a provision permitting it to terminate the lease after a certain period of time if the tenant has not resumed its full rent payments.

Some landlords prefer a provision stating that after a year (or other period) of reduced rent, the lease will automatically terminate unless the tenant recommences paying full rent. This approach may not, however, give the landlord the flexibility to keep the tenant in place, paying the reduced rent for the extended period that proves to be necessary.

Landlords should also be wary of tenant remedy language that allows the tenant to pay reduced rent based on a percentage of sales after a short period, and either immediately or after a longer period, to go dark if a co-tenancy violation occurs. Read literally, such a provision would permit the tenant to keep the lease in place without paying any rent until the co-tenancy violation is cured. The landlord should be sure to use language stating that the reduced rent is payable *only* if the tenant is open and operating in accordance with the requirements of the lease.

Even with the benefit of reduced rent, the tenant will want to have the option of terminating the lease if a co-tenancy violation continues for a year or longer. Although the tenant may

also want to have the option of going dark without terminating (even if it must continue to pay fixed rent), most landlords would prefer a terminated lease to a closed store—particularly if the tenant's closing will cause the shopping center to be in violation of other tenants' co-tenancy provisions. If the landlord has invested a large sum in tenant improvements, the tenant may be required to reimburse the landlord for the unamortized portion of its investment if it terminates. This should be one of the landlord's considerations in both negotiating the co-tenancy clause and in deciding on the amount of tenant improvements it will finance.

Conclusion

Tenants have a valid concern that they should not have to operate at a loss in a half-filled shopping center. Landlords, on the other hand, need a fair opportunity to replace lost tenants, even if it takes longer than the remaining tenants think is necessary. If the loss of a few tenants gives all of the others the right to close or terminate, then a center can quickly become a ghost town. The solution for both parties is to craft a co-tenancy provision that considers the amount and duration of closed space that will be truly damaging to the tenant's operations; the rental terms that will induce the tenant to remain open and operating, even if other tenants have closed; and the length of time the landlord must realistically have to restore the center's occupancy before the tenant may close or terminate. ■

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