In today's economy, most national retail tenants demand assurance that they will not be the last tenant left standing in a shopping center. After all, most tenants sign a 5- to 10-year lease obligating the tenant to operate continuously, and the tenant's worst nightmare is being forced to operate alone in an otherwise empty center. To provide themselves an escape if the other tenants start leaving the complex, national retail tenants generally require that their leases include "co-tenancy" provisions that permit them to close ("go dark"), to pay reduced rent, and to terminate after a period if a certain number of the biggest and most important stores in the center (the "anchor" tenants) close or if fewer than a certain percentage of smaller stores (the "in-line" tenants) are open.

These clauses can be very dangerous for landlords. If too many anchor or in-line tenants close their stores, the landlord could face a domino situation in which all of the other tenants automatically have the right to walk away from their leases. Also, the landlord is likely to have paid for some or all of the tenant's interior improvements or, in some cases, even to have built the tenant's store in accordance with the tenant's plans. If the landlord cannot amortize these costs by rent paid for the full term of the lease, the landlord will suffer a real monetary loss.

For these reasons, landlords must be very careful to draft co-tenancy provisions realistically, with full consideration of the size and configuration of the center, the terms of the leases that are in effect for the center at that time, and potential weather hazards and other risks that may face the property. For the same reasons, the landlord's lawyer should be sure that the client understands the risks posed by a co-tenancy provision and should minimize these risks in response to the landlord's business concerns.

Anchor Tenants

Most shopping centers have at least one anchor tenant. This anchor tenant is the

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Lease Co-tenancy Provisions

Protecting Retail Tenants While Giving Landlords a Fair Chance to Maintain Vibrant, Tenanted Centers

By Marie A. Moore

to be a reasonable remedy because the tenant's actual sales are the best measure of whether it has been hurt by the co-tenancy violation. In some cases, however, the tenant may insist on paying a lower percentage of sales than it would normally pay if there is a co-tenancy violation. For example, a tenant that normally pays $1,000 of annual fixed rent plus 6% of annual gross sales to the extent that the gross sales exceed an annual break point (the most customary break point in this instance would be a "natural breakpoint" of $16,666.67, which is $1,000 divided by .06) may ask that, during a co-tenancy violation, it be permitted to pay only 4% of its sales, with no break point, as its sole rent. In addition, many tenants demand that this percentage rent payable during a co-tenancy violation be no more than the fixed rent they would normally pay. The tenant also may ask that this percentage of sales be a substitute not only for the fixed minimum rent, but also for the tenant's percentage of the center's operating expenses, taxes, and insurance.

If the landlord permits the tenant to pay rent of only a percentage of sales during a co-tenancy violation, the landlord must specify that this reduced rent is payable only while the tenant is open and operating. Although it seems clear that if a tenant is paying only a percentage of sales then it should not be permitted to stop operations, because that also will stop all rent, tenants generally ask for both of these remedies together. When the landlord points out that a closed store will generate no sales and no rent, the tenant usually agrees that its right to pay only the percentage rent depends on its continued operations.

If the co-tenancy violation continues for a long period of time such as a year, without remedy, both parties will want the legal right to change the arrangements. On the one hand, the tenant will demand the option of terminating the lease. On the other hand, the landlord will want the right to demand that the full rent be paid once again, and if the tenant will not pay full rent, the landlord will want the option of terminating the lease and finding a new tenant. Some leases provide that the lease will terminate automatically if the tenant does not start paying full rent after a stipulated period, but the landlord's goal may be to keep the tenant operating in the space, even if the tenant is paying reduced rent, and an automatic termination provision will not give the landlord the flexibility it needs in an extended retail downturn.

The landlord is likely to have provided the tenant with an initial tenant improvement allowance, which may be a substantial sum. When it negotiates this tenant improvement allowance, the landlord may be able to require that the tenant reimburse it for some or all of this allowance if the tenant terminates. In the current retail environment, however, only a landlord with an exceptional location will be able to obtain reimbursement if the tenant elects to terminate after the co-tenancy requirements have continued for a long time.

The landlord also may make the equitable argument that if the tenant's sales are not diminished, the tenant is not entitled to exercise remedies. Consequently, unless the tenant shows that its sales after the co-tenancy violation are substantially lower than its sales before that violation, the tenant should not be entitled to terminate the lease, or even obtain reduced rent. Again, in this retail environment, only a landlord in a strong retail market or with a very attractive location will be able to require that the tenant show a drop in its sales before exercising co-tenancy violation rights.

Additional Clauses Important to Co-tenancy

Although national retail tenants are not shy about asking for rights if other tenants are not open and operating, few are willing to offer to operate their own stores in the center continuously. Tenants are concerned that if the new location does not prove profitable, a continuous operation clause might require them to keep the store open at a loss. Because many tenants in the center have co-tenancy provisions in their leases, it is crucial to the landlord that all tenants—or at least the required amount—remain open. The landlord must keep its eyes on the co-tenancy requirements of the other leases at all times when it is negotiating with a new tenant. If that new tenant will not agree to operate continuously, then the landlord may want to reconsider the tenant or at least the amount that it will pay to construct the tenant's improvements. If the landlord decides to go forward without a continuous operation provision, it should negotiate a right to take the space back if the new tenant closes and perhaps a way to recover at least some of its tenant improvement allowance.

The parties also should make changes to the other rent provisions to deal with co-tenancy situations in which the tenant's rent becomes strictly a percentage of sales. The co-tenancy provision should clarify that during the reduced rent period, the tenant must pay the full required percentage of the sales within a certain number of days after each month, generally when it delivers its normal monthly sales report to the landlord.

If ordinarily the tenant pays the landlord a percentage of its sales to the extent that the sales exceed a break point, then the tenant should expressly exclude its sales during the reduced rent period from the calculation of the percentage rent payable when there is no co-tenancy violation, to avoid a double counting of those sales. On the other hand, the landlord should stipulate that the break point is reduced in proportion to the period during which the tenant pays reduced rent.

Conclusion

Although landlords would like to just say "no" to co-tenancy provisions, tenants are unlikely to give them up. Even before a poor sales climate forced retailers to close stores and leave markets, tenants recognized the importance of being a part of a critical mass of other businesses that, together, draw shoppers to a development.

Tenants have good reason to insist on co-tenancy requirements, but landlords and the lawyers that represent them should be sure that these requirements are realistic in light of the center, its market, and its configuration. Landlords also should include the protections that give them a fighting chance to maintain a vibrant, tenanted shopping center except in the most dire of circumstances. ■

main attraction, the store that brings most of the customers to the center. In a strip center located in a small town or a suburban location, the shopping center may be anchored by a grocery store or a Wal-Mart, K-Mart, or Target. In a large regional mall, there are usually several anchors, including two or more department stores. In an upscale urban center or a lifestyle center, the anchor may be only one, very upscale, fashion store, such as a Saks Fifth Avenue or Neiman Marcus.

Many national tenants enter negotiations with the demand that the closing of any anchor tenant will violate the co-tenancy requirements. The landlord should be wary, however, because some large department stores are consolidating and others are going out of business. If the center contains more than one anchor store, the landlord should request that the tenant's remedies not be available unless all of the anchor stores close. The parties should be able to compromise on the number of these anchor tenants that must be open and operating—perhaps one out of two, or two out of three or four.

In any case, the landlord should avoid being stuck in the trap of naming the anchor store or stores that must be open. A Circuit City today may be a Best Buy tomorrow. The landlord should tie the open-and-operating requirement to the anchor tenant space, not the particular anchor tenant, and ask the tenant to accept an open-and-operating anchor space, regardless of the identity of the tenant. Many tenants, however, want a certain type or quality of store in the anchor space, particularly if the center contains only one or two anchors, and particularly if the center has a certain identity in the marketplace, whether as a big-box regional center or a high-end lifestyle or enclosed urban center. In these cases, the tenant's business needs dictate that a certain type of nationally known store must be operating in the anchor tenant space. These tenants should agree to accept a replacement anchor tenant as long as this anchor occupies substantially the same space as the original tenant and has an equivalent or better national or regional reputation, though the wording of this provision will vary depending on the tenant's business concerns. If the type or quality of the products to be sold by the anchor is important to the tenant, then the tenant may require that the co-tenancy provision specify a replacement anchor's product range, and perhaps even the general price point at which these products are to be sold.

If it can, the landlord should preserve a right to split up an anchor space into more than one store. For example, the landlord may be able to place a substitute tenant in two stories of a three-story anchor space, or lease each story of the space to a different tenant, or even lease the space to different concept stores owned by the same parent (for example, Old Navy, The Gap, and Banana Republic). This negotiation will depend on the original configuration of the anchor space and the willingness of the tenant to accept a smaller anchor.

In-Line Tenants

Even if the anchor tenants are open and operating, a new retail tenant will need assurance that a certain percentage of the smaller spaces stretching out on either side of the anchor or, in an enclosed center, lining the interior corridors of the center will be open and operating. This percentage may range from 50% to 80% of the available in-line retail space. Generally, this percentage is a percentage of the square footage of the available in-line retail space, not a percentage of the tenants.

Normally, anchor tenant space and the premises to be leased by the new tenant are excluded from this available in-line space. Also, the landlord will want to exclude space used for the center's management and may want to exclude space in the food court as well as space leased for nonretail purposes (unless the tenant is willing to consider a use such as an insurance agency, a chiropractor, or a check-cashing service as space that is open and operating for purposes of its co-tenancy requirement).

Another important exclusion is space that is on a separate parcel on the periphery of the development (an "outparcel"), such as a restaurant separated from the rest of the center. Landlords frequently sell outparcels and thereby lose control of their use and occupancy. In addition, whether a business located on an outparcel is open and operating should not affect the business of a tenant whose store is attached to the mall or strip shopping center. But in a lifestyle center or in the case of a big-box tenant that brings many shoppers to the development, the tenant may not accept this exclusion.

The landlord should exclude space that is not really important to the tenant. For example, if an enclosed mall contains three floors of retail space and the tenant's store will be on the first or second floor, then the tenant should not care whether the third floor is fully tenanted. For that reason, the landlord should be able to convince the tenant to include only space on the first two floors in its co-tenancy calculation.

A current tenant trend is to require that a certain number of named tenants be open in the center in addition to the required percentage of in-line tenants (though the space occupied by the named tenants will be included in the calculation of the in-line percentage). Again, naming tenants can be a trap for the landlord because concepts can change quickly, and today's hot store may not be tomorrow's hot store. As in the case of more than one anchor tenant, the landlord should commit to having only a certain realistic number of the named stores open and should give itself the right to substitute for any of the named stores a national or regional operation that is of comparable quality.

The landlord also should resist any attempt by the tenant to exclude temporary tenants from the space considered to be open and operating. Many retail tenants can be enticed to a center today only on a month-to-month basis. To minimize empty space, a landlord is generally willing to lease empty space on a month-to-month basis to a tenant that agrees to operate actively so long as the landlord is not required to spend money to improve the space for the tenant's occupancy. These temporary tenants can remain in the space for years, and as long as the space is open for business, the tenant should not mind the "temporary" nature of the occupancy. The tenant, however, may want the landlord to disclose if any of the other tenants in the center are not bound by a long-term lease.

Finally, in determining the in-line

co-tenancy percentages and the space that will be considered in the calculation, the landlord should look very closely and realistically at the footprint of the existing leases. The landlord should consider the remaining term of the existing leases in light of the possibility that it may not be able to find new tenants easily after these leases expire. It also should consider whether particular spaces are chronically empty and attempt to exclude those spaces from the co-tenancy calculation.

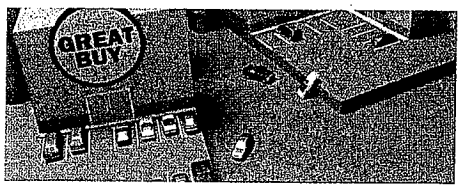
Timing

A national tenant will ask that it have the right to terminate its lease the minute the closed space in the center exceeds the amount permitted in the lease's co-tenancy provisions, but this would be very dangerous for the landlord. On the one hand, if an anchor or in-line tenant closes, the landlord needs an adequate amount of time to replace that tenant. On the other hand, the tenant does not want to be operating in an anchorless or half-empty center for very long unless it is clear that a new tenant is on the way. These conflicting concerns are generally resolved by giving the tenant one remedy, a rent reduction, a few months after the co-tenancy violation occurs and the drastic remedy of termination only if the violation continues for a long period, perhaps a year.

Many national retail tenants now require that a certain number of anchors and other tenants be open before the rent will commence and before they are obligated to open initially. This requirement is crucial to the tenant if the shopping center has not yet opened, but this clause also appears on tenant checklists for centers that have been in operation for some time. The tenant is unlikely to grant extensions of time for compliance with this requirement except, possibly, for casualty. It is also likely to insist that a certain number of its named tenants, not comparable replacements, be open and operating before its rent and operating requirements will commence.

Casualty and Remodeling

If a fire, hurricane, windstorm, flood, earthquake, or other casualty damages the center, the landlord needs sufficient time to restore the space and to require the tenants to re-open. Unless the parties already have experience with casualty losses, they will be shocked by the actual amount of time it can take to obtain the insurance proceeds and restore the center. The landlord should ask that the required time for curing co-tenancy violations be extended by the time necessary to receive insurance proceeds and restore the property. Of course, the



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tenant is likely to ask for limits on that time, but the landlord should strive to have a long repair period, 18 months or an unspecified "reasonable" period if possible, before the tenant will have the right to terminate. A tenant occupying undamaged space in a substantially damaged center may be entitled to reduced rent while it waits and may ask that the landlord start repairs to the rest of the center promptly and proceed with them diligently to completion. If the premises themselves or the necessary common areas are damaged and not restored promptly, the casualty provisions of the lease will also provide the tenant with a termination period, and the landlord's lawyer should assure that the casualty and co-tenancy provisions are harmonized.

Remodeling by an anchor or in-line tenant can also extend the landlord's cure period. After all, an updated anchor or in-line space will benefit the center as a whole. The tenant will wish this period to be limited to a few weeks, but the landlord should ask for a longer period, particularly for anchor tenants.

In addition, the landlord should ask that the cure period for anchor tenant co-tenancy violations be extended if the landlord has entered into a lease with a new anchor that satisfies the tenant's requirements. The tenant, however, might ask that this new lease contain a requirement that the new anchor be open within a certain period.

Tenant's Remedies

Retail leases generally provide the tenant with the successive remedies of a lower rent, then a termination right, if the co-tenancy requirements are violated and the violation continues uncured for more than a stated period. Most landlords would rather give the tenant a rent reduction than a right to terminate or a right to close, but at some point most tenants will insist on being able to walk away from the center.

Initially, a tenant may request a right to go dark if the co-tenancy requirements are not satisfied for a certain period, with a right to terminate if they remain unsatisfied for a longer time. The landlord may require the tenant to pay fixed rent while it is closed, but landlords should understand that a closed tenant whose lease remains in effect is in some ways worse than a tenant that has terminated its lease. If the tenant terminates, at least the landlord has a chance to fill the space with a new, operating tenant. Consequently, to keep all of the tenants open and operating while their leases remain in effect, the tenant's rights should be restricted to a rent reduction or lease termination. If the landlord does agree to permit the tenant to close without terminating its lease, the landlord should reserve a right to terminate the lease at any time before the tenant re-opens so that it can substitute a new open tenant for the old closed one.

If the co-tenancy requirements are violated for an initial period, perhaps several months, then the tenant is generally permitted to pay a lower rent. Frequently, the minimum rent is eliminated, and the tenant pays only a percentage of sales. This percentage is often the same percentage used to calculate percentage rent, but with no break point (an amount of gross sales that must be reached before the tenant is required to pay percentage rent). This seems