New Jersey Law Journal

VOL. 209 - NO 8 AUGUST 27, 2012 ESTABLISHED 1878

IN PRACTICE

REAL ESTATE LAW

Strategies for Retail Landlords To Mitigate Cotenancy Risks

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Cotenancy provisions grant rights and remedies to tenants when certain requirements are not satisfied by their landlords or other tenants in a shopping center. Many such rights and remedies in retail leases were triggered during the "Great Recession," when consumer spending weakened and vacancies rose. This had a devastating domino effect on some retail landlords, because the termination of one lease triggered remedies under other leases, such as termination rights and reduced rent. Many properties became subject to receivership, foreclosure and forced sales at distressed prices, partly as a result of these remedies being exercised. Retail landlords must learn from these experiences and utilize that knowledge in negotiating and drafting cotenancy provisions in future leases.

Cotenancy Provisions

Cotenancy provisions condition a retailer's obligation to commence construction, open and/or remain open for business upon the execution of other leases, the commencement of construction, opening for business and/or the continued operation of other tenants' businesses (i.e., "cotenants"). Opening cotenancy provisions are often contained in leases for premises in shopping centers being developed, renovated or redeveloped. These clauses may require that common areas and infrastructure improvements be completed, and that a certain minimum percentage (e.g., 65-85 percent) of the rest of the shopping center be leased to cotenants. It may also require that certain identified cotenants sign leases and be open for business, to assure protected retailers that shopping centers will be operating at sufficient capacity. Insufficient foot traffic because of low occupancy generally results in lower sales than anticipated. Landlords prefer *not* to provide cotenancy protections because they may jeopardize cash flow, the ability to obtain financing, the value of the real estate and, ultimately, the success of the shopping center. However, landlords often agree to grant cotenancy protections because they are required to do so as a condition of attracting tenants with strong credit, including national retailers.

Cotenancy Percentage Formulas

Landlords must make sure that all definitions and cotenancy percentage formulas are crystal-clear to avoid future disputes. The numerator in the formula is usually the gross leasable area (GLA) of the shopping center leased by other tenants. GLA is typically defined as the total enclosed floor area designed for the exclusive use of an occupant, including any basements, mezzanines and upper floors. The denominator in the formula is the total leased and unleased GLA of the shopping center, excluding the premises leased by the protected tenant. Proposed but unbuilt pad sites are not enclosed areas and, therefore, by definition, are not included in GLA. Landlords may want to exclude pad sites from cotenancy formulas because they are often sold to third parties and are subsequently outside of their control.

Anchor Tenants

Tenants decide to open for business in a shopping center in part to benefit from expected synergies and traffic generated by co-tenants. Co-tenants identified in cotenancy provisions and viewed as crucial to the success of the shopping center and to the operations of other tenants, are sometimes referred to as "anchors." There are multiple definitions for anchors, but the common theme among them is that certain companies have a prestige and name awareness that attracts other tenants. For example, Michaels may open in a shopping center where Kohl's is the primary draw, and Dollar Tree may open where ShopRite is the main tenant. Department stores and supermarkets have traditionally been regarded as anchors, but the term "anchor" is defined in leases based on

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the agreement of the parties. For example, an anchor can be defined simply as any tenant occupying premises greater than 50,000 square feet in a particular shopping center. Landlords should try not to name specific anchors, and instead link the requirement to the occupancy of a particular anchor *space* regardless of the tenant's identity.

Before agreeing to offer protections based on specifically identified anchors, landlords should analyze the risk that an anchor may cease operations. For example, is the anchor obligated by its lease to continuously operate? Is the anchor profitable? Landlords should also negotiate for flexibility in replacing the anchor. Pro-tenant opening cotenancy provisions often require that the anchor be open and operating for business. However, from the perspective of landlords, the opening cotenancy condition should be satisfied as long as the anchor has started construction. This is especially important when anchors are not obligated to open or pay rent during temporary periods, commonly known as blackout periods, in recognition of their cyclicality or business model. For example, some national retailers such as Kohl's prefer to open a large number of stores simultaneously to maximize the benefit of national advertising campaigns.

Violations and Cure Rights

From the perspective of landlords, tenants should only be entitled to claim cotenancy violations and exercise remedies if they are not in default and are open for business. Landlords also prefer that cotenancy rights are personal only to the original tenants, and that inventory closures, closures in connection with a transfer of possession and force majeure events do not constitute cotenancy violations. As a general rule, landlords should negotiate for flexibility by drafting their rights as broadly as possible so they may adapt to changes in retailing. Careful drafting is crucial to avoiding disputes and litigation. For example, is a strong and stable retailer operating in only 40 of the 50 states considered a "national retailer"? Landlords do not want a judge answering such questions.

Landlords should have a reasonable opportunity to cure defaults, with the cure period varying depending on the available remedy. For example, if cotenancy requirements are tied to the occupancy of named anchors, landlords will need a significant period of time to find a replacement tenant or tenants. Landlords will want to have the broadest possible rights to substitute a tenant that will be a similar draw to the shopping center, whereas tenants want to narrowly define the universe of acceptable replacement tenants.

Landlords also want flexibility to adapt to different uses that become popular and replace traditional anchors. For example, if a 100,000 square-foot department store vacates and must be replaced, a new lease with a comparable tenant, or two comparable tenants collectively taking between 85-100 percent of the vacated premises, should cure the default. Tenants have the opposite incentive and want approval rights with respect to replacement tenants in their sole and absolute discretion. If tenants' approval is required, landlords should require that such approvals will not be unreasonably withheld, conditioned or delayed.

Remedies

Remedies are often the subject of zealous negotiation, including rights to: (i) refrain from opening; (ii) go dark (i.e., cease operations); (iii) pay reduced rent; and/or (iv) terminate the lease. Tenant-friendly leases allow tenants to pay a lesser amount or percentage (e.g., 50 percent) of base rent in lieu of all base rent and additional rent. Landlords should attempt to hold the line by requiring payment of full additional rent even if base rent is reduced. Alternatively, rent may be reduced to a percentage of gross sales, which should be avoided from the perspective of landlords because there is usually no relationship to actual damages. Landlords should define gross sales as clearly and broadly as possible and obtain audit rights to verify gross sales.

Landlords should try to obligate tenants to suffer a material reduction in sales before they are entitled to pay alternative rent. Otherwise, a 2 percent reduction in sales may result in a 50 percent or greater rent reduction, which makes no economic sense. In any event, the reduced rent remedy should not be available indefinitely and should be limited to six to 12 months. Thereafter, tenants should be obligated to resume paying full rent or terminate their leases. If tenants will not agree to return to full rent after a finite period, landlords should obtain the right to recapture the premises and terminate the leases so that new tenants willing to pay full rent can be substituted. Landlords should also have a longer cure period (e.g., six to 24 months) before tenants can exercise their termination remedies, as compared to the cure period available with respect to other, less drastic remedies.

Additional Landlord Protection Strategies

Landlords must protect themselves to mitigate cotenancy risks. If letters of intent are utilized, landlords should aggressively negotiate cotenancy issues at that stage rather than simply agreeing to cotenancy language provided by tenants with the intent to subsequently flesh out the issues in the leases. Each remedy should require prior written notice to landlords, and tenants should be obligated to pay termination fees, including the unamortized portion of landlords' out-of-pocket costs in connection with the leases. Landlords should amortize such costs over as long a period as possible. They should also try to limit cotenancy requirements to the initial lease term (or a shorter period), because tenants need the greatest protection while new stores are being established and thereafter can fend for themselves.

Leases should provide that the remedies selected by tenants following a cotenancy violation are sole and exclusive remedies, so that tenants cannot pay alternative rent or terminate their leases and still sue for damages. Landlords should also insist that all tenants in their shopping centers be subject to continuous operations covenants to reduce the risk of cotenancy violations. When negotiating cotenancy provisions in letters of intent and leases, landlords should keep these mitigation strategies in mind, in order to successfully limit the risk that their cash flow position will be significantly weakened and the value of their properties will decline. ■