ALERT MEMORANDUM

Retail Co-Tenancy and COVID-19

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Why Retail Tenants May Invoke Rights To Reduced Rent or Termination in Coming Weeks

With COVID-19 emergency orders in place, many malls have shut their doors and U.S. retailers have gone dark. What does this mean for retail landlords whose tenants have co-tenancy provisions in their leases? Much depends on the details of the particular clause.

Will Co-Tenancy Rights Kick In?

A co-tenancy provision (obligating a landlord to maintain a certain percentage of open and operating space within a shopping center and/or the continued operation of specific named anchor tenants) typically requires that the subject stores be closed for a period of time before co-tenancy rights are triggered. In many leases, a mere 30 or 60 days of store closures will not grant a tenant any remedies under the co-tenancy provision but may grant an intermediate remedy such as reduced rent. The co-tenancy provision is often subject to a cure period, sometimes of up to a year, before a tenant gains the right to terminate the lease. It is important to analyze co-tenancy provisions carefully, as they vary widely from lease to lease. Depending upon the specific clause, and how long the pandemic-induced shutdowns last, co-tenancy rights, if triggered, create a potential point of leverage for tenants and a source of heightened risk for landlords.

Are Co-Tenancy Provisions Enforceable?

Assuming the current pandemic lasts long enough to trigger a tenant's rights under a co-tenancy provision, those rights are most likely enforceable. Courts in many states have found that co-tenancy clauses are enforceable under general contract law principles – for a quick reference guide to New York, California, Texas and Illinois, see the chart [here]. As long as the provision evidences the intention of two sophisticated parties who reached an agreement after arm's-length negotiations, it will likely be enforced as written. As with other contract provisions, courts may look for extrinsic evidence of the parties' intentions if the language of the clause is ambiguous.

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One notable exception, applied by a California appellate court in the 2015 case *Grand Prospect Partners, L.P. v. Ross Dress for Less, Inc.*, is when a remedy under a co-tenancy provision bears no reasonable relationship to the harm suffered by the tenant. In that case, the tenant's lease entitled it to full rent abatement if the landlord failed to meet the co-tenancy requirement for the shopping center's opening day, and to continue paying zero rent until permitted to terminate the lease after one year. The court held the full rent abatement to be an unenforceable penalty. Courts have repeatedly upheld less extreme rent reduction rights.

Is There a Force Majeure Exception?

If a lease contains a force majeure exception to the co-tenancy obligations of the landlord, depending on how broadly worded, COVID-19 may be considered a force majeure event. Although few contracts specifically contemplate a pandemic, a state of emergency or other government intervention may fall within some force majeure definitions. If the co-tenancy provision specifically carves out store closures due to force majeure from the landlord's co-tenancy obligations, then the tenant's rights would not be triggered. If the co-tenancy provision is silent on force majeure, however, an exception is unlikely to be implied. Regardless of whether a co-tenancy clause contains a force majeure exception, it is unlikely such clauses contemplate the complete government-mandated shutdown of an entire mall. Under these circumstances, it may be difficult to argue that a tenant is damaged by the failure of certain anchor stores to operate, when the tenant itself is otherwise prohibited from operating by the emergency order. At this juncture, it is impossible to predict how courts would react to such an argument.

It is still unknown how many weeks or months COVID-19 will keep retailers shuttered, and how many tenants will attempt to exercise co-tenancy rights. While co-tenancy provisions are largely enforceable, the uncontemplated circumstances caused by COVID-19 may prompt courts to exercise their equitable powers in interpreting such clauses. A court might find, as in *Grand Prospect Partners*, that the remedy set out in a retailer's co-tenancy clause bears no reasonable relationship to the harms caused by mall closures due to COVID-19. Alternatively, a court might take an approach more like the Second Circuit in the 1995 case *Herman Miller, Inc. v. Thom Rock Realty Co., L.P.*, and quantify what percentage of diminution in value of a lease is attributable to the breach of the co-tenancy clause – which, under pandemic conditions requiring both the landlord and tenant to go dark, might be zero. Or, given the unique circumstances, courts may stretch their interpretations beyond the existing co-tenancy case law and find an altogether new approach.

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