

# Untangling lease co-tenancy

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**CO-TENANCY** provisions have become commonplace in outlet-center leases, regardless of whether the project is a new phase 1 development, an existing center or a conversion from a traditional retail center. Successful outlet sites require a certain mix of well-known, national tenants to draw traffic. For their part, national retailers, concerned about the initial viability of a shopping center and its continuing success, want landlords to guarantee specific tenant mixes and/or occupancy rates. If those don't come to pass, the retailer wants a greatly reduced rent or a termination right, or both.

During the Great Recession of the past few years, a number of retail chains failed, which left gaping holes in some centers. Funding for retail development began drying up, so projects were delayed and delivery dates were missed. All of this triggered co-tenancy clauses, which led to a domino effect that compromised rent streams, over which landlords had no control.

Consequently, co-tenancy provisions have become one of the most litigated of all lease provisions, second only to those dealing with common-area maintenance. Here are the issues most often raised and how each one affects landlords and tenants:

## Types of Co-Tenancy Provisions

Co-tenancies come in two categories:

- ✓ A "named co-tenancy" specifies certain other tenants that are required to be under lease.
- ✓ The "occupancy threshold" co-tenancy states that a percentage of a center's gross leasable area must be leased.

Generally, the named co-tenancy clause is more complex, as it creates layers of top-tier tenants that are required to be in the center, with little or no flexibility for substitution. The occupancy threshold requires a minimum number of tenants out of a larger group – i.e., tenants X and Y plus eight of the following 12 named tenants – in order to satisfy co-tenancy. Clearly, the landlord's ability to substitute tenants is critical. Even in the best markets and strongest outlet centers, circumstances will arise that require substitution.

## Stages of Co-Tenancy

Depending on the nature, maturity and expected tenant mix of the shopping center, co-tenancy provisions can include any, or all, of the following requirements, which apply at different stages of the lease:

**Inducement/execution co-tenancy:** This means that before the center is completely leased the landlord must show that it has attained a specific occupancy or that certain other tenants have signed leases. This provi-



sion is quite onerous for the landlord, as it can lead to delays and penalties before leasing gets off the ground. Even when leasing is going well, tenants who are committed to the project might not execute leases in time to satisfy these requirements.

For a retailer, though, this requirement provides some assurance that the center will actually be built with the promised tenant mix.

**Construction/delivery co-tenancy:** The delivery co-tenancy, in many respects, mirrors the inducement co-tenancy because it is based on the number of leases already executed. However, it also requires that leased space has been delivered to tenants and that construction on stores has begun by the time the landlord delivers the premises to the tenant.

This provision exposes the landlord to late-delivery penalties, even if the landlord's construction requirements and all other delivery conditions have been met. If possible, landlords would love for tenants to waive this requirement once other tenants start construction.

For tenants, though, construction/delivery

co-tenancy protection is important. Once a tenant accepts delivery of its space, the clock for constructing and opening the store starts ticking. Not only will the tenant spend a significant amount of money on construction and fixturing, but it might have to start paying rent before the project is fully leased and truly complete.

**Opening co-tenancy:** Before a tenant opens, it wants to know that named co-tenants or a certain number of tenants have opened or are making preparations to open. Landlords want tenants to agree to open, even if other requirements haven't been met. They often allow tenants to go to an alternate rent structure until the conditions are satisfied.

This compromise can prevent a domino effect of tenants failing to open because occupancy levels are too low. Landlords will also want the ability to replace named co-tenants with comparable replacements, but those criteria should be spelled out in advance. Landlords should require a provision mandating the tenant to either terminate or resume payment of full rent after a specified period of time.

No tenant wants to open in an empty center or with its neighboring stores under construction. The tenant has bargained for, and been assured of, a specific tenant mix and they might not want replacements.

**Operating/ongoing co-tenancy:** To ensure that they won't be stuck in a dying center, tenants often make continued operations contingent on certain other tenants – or a certain number of tenants – being open and operating.

A landlord will want to make sure of the reasons (remodeling or a catastrophe) that a tenant has to close or operate in less than all its space. And a landlord will want a window to cure any co-tenancy failures. Landlords should require tenants to either terminate their leases or resume payment of full rent after a specified period of time. Landlords should also limit co-tenancy to the initial phase if they are planning a multi-phase development.

A tenant wants the flexibility to leave the center if the occupancy level drops or if the appropriate tenant mix is no longer there. An ongoing right to pay alternate rent (while retaining the ability to terminate the lease) is preferable. Tenants should also insist that leases have a minimum term so that short-term pop-up stores aren't used to artificially prop up occupancy levels and limit co-tenancy violations.

In conclusion...

A center can change dramatically over the course of a 10- to 20-year period, so a detailed co-tenancy agreement – starting with the letter of intent – can avoid aggravating delays later on. Common ground must be found to give the landlord flexibility while ensuring that tenants have viable exit strategies. ▀



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