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PROPERTY
— LEASING UPDATE

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Leasing Lessons from California: Is Your Co-Tenancy Clause Enforceable?

Most Canadians are familiar with many of California's notable attributes – from Hollywood, to Silicon Valley, giant redwoods, the former "Governator", Napa Valley wines and Alcatraz. However, outside of certain high-profile criminal cases we rarely hear about California court decisions. Nevertheless, landlords and tenants should take note of a recent California Court of Appeal decision dealing with an issue that has not received much attention in Canada: Are co-tenancy clauses in commercial leases enforceable?

As a starting point, a co-tenancy clause usually gives a tenant the right to terminate its lease and/or pay reduced rent if a prescribed percentage of the shopping centre becomes vacant, or if certain anchor tenant(s) fails to open or leaves the centre. The clause comes in two forms. An opening co-tenancy clause requires that one or more specific tenants, a certain percentage of the centre, or a certain number of tenants must be open and operating prior to the tenant opening for business. An ongoing co-tenancy clause states that the tenant will continue to operate and pay full rent provided that one or more named co-tenants remain open and operating, or a certain percentage or number of tenants in the centre remain open and operating. While leases typically use either an opening or an ongoing co-tenancy clause, are either enforceable? According to the California Court of Appeal, the answer (at least in California) is: "it depends".

In *Grand Prospect Partners, L.P. v. Ross Dress for Less, Inc.,* Ross was given an opening co-tenancy clause which did not require Ross to open its store or pay rent until both Target and Mervyn's, a department store, were open for business. The clause also said that if the co-tenancy requirement was not met within 12 months of Ross taking possession of the premises (but not opening), Ross could terminate the lease. Ross took possession, but, before it opened, Mervyn's went bankrupt and closed its store in the shopping centre. As a result, the co-tenancy requirement was not satisfied and Ross elected to not open and not pay rent. After the 12-month period expired, Ross terminated its lease.

The landlord sued, arguing that the co-tenancy clause was unconscionable and constituted an unlawful penalty. The California Court of Appeal agreed with respect to the rent abatement component. This conclusion was based on the general principle that a contractual provision is an unlawful penalty if the value of the money or property given up under it is not reasonably related to the harm that is anticipated to be caused. The court accepted findings of fact by the trial judge (based on e-mails and the testimony of company executives) that Ross did not think the closure of Mervyn's would have any measurable impact on their store (i.e., no lost sales). As a result, the Court of Appeal held that Ross had breached the lease and was required to pay $672,100.00 in damages in respect of the rent payments it did not make prior to terminating the lease. The Court of Appeal disagreed, however, with the trial decision that the termination right was also unenforceable, on the grounds that neither party had any control over the closure

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of the Mervyn's store and the closure had no relationship to any act or default of Ross. The court also took pains to note that the determination of the enforceability of a co-tenancy provision depends heavily on the facts of each case. This is particularly important in this case, as the absence of a time limit on the rent abatement is rather unusual.

While a California decision is not binding in Canada, its lessons should not be ignored by landlords and tenants north of the 49th parallel. For one thing, Canadian courts have rarely been asked to address co-tenancy provisions. In fact, we could only find two examples. In *T. Eaton Co., Re*[1] the court made an order that prevented tenants at retail shopping centres in which Eaton's was an anchor tenant from terminating their leases during Eaton's restructuring period. Similarly, in *Target Canada Co., Re*[2] the court granted a stay preventing third-party tenants from exercising their co-tenancy rights while the court-supervised restructuring process was underway.

Second, the California Court of Appeal's assessment of the rent abatement as an unlawful penalty is not dissimilar to what Canadian courts have held regarding penalty clauses. Like California, under Canadian law, penalty clauses (i.e., those which specify the payment of an amount upon a breach regardless of the damages actually sustained) are generally not enforceable. In order to avoid a clause being characterized as such, the amount to be paid needs to be a reasonable and genuine pre-estimate of damages. A court may find that the clause is not enforceable if both of these elements are not present.

Assuming that Canadian courts follow California's model, the lesson to be learned is that in order for a rent abatement provision in a co-tenancy clause to be enforceable, the abatement needs to be reasonably limited, with respect to both the duration of the abatement and the expected damages suffered by the Tenant. The limitation on the duration of the abatement is likely not a significant issue, as although the co-tenancy clause in Ross's lease contained no such limit (thereby allowing the tenant, if they did not terminate the lease, to pay a reduced rent for the entire 10-year term), most co-tenancy clauses provide that if the co-tenancy violation is not cured within 12 months, the lease either terminates or the Tenant goes back to paying full rent.

Determining the tenant's damages, however, gives rise to the practical dilemma of measuring the quantum of damages. After the tenant has been operating, it could presumably provide monthly sales reports to show a decline in sales. But what if it is not yet open and has no sales reports to compare? Could a tenant present evidence of the performance of other stores in a certain region to show a drop in sales? Where the tenant cannot show it has suffered any reduced sales, but its lease says it is entitled to pay a reduced rent for a certain period as a result of the co-tenancy failure, is the time limitation by itself sufficient to make the clause reasonable? Would a court consider non-monetary damages, such as loss of prestige to the shopping centre, in determining whether the abatement is reasonable? There are no clear answers here.

Perhaps a Canadian landlord will feel daring enough to challenge the enforceability of a co-tenancy clause and provide a Canadian court with the opportunity to consider these issues. Until that time, the California Court of Appeal provides some guidelines, as well as some food for thought for Canadian landlords, tenants and their lawyers in negotiating and drafting co-tenancy clauses.

1 (1997), 46 CBR (3d) 293 (Ont Gen Div).
2 2015 ONSC 303.

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