

# ROSS DRESS FOR LESS LOSES ITS SHIRT IN COTENANCY CLAUSE FIGHT

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Our firm has watched the law regarding cotenancy provisions evolve for many years. This month, the Fifth District appellate court decided an interesting cotenancy clause case. The suit centered on the cotenancy provisions in a highly negotiated retail lease between two sophisticated, financially stable parties represented by counsel. The cotenancy clause allowed the tenant to occupy the leased premises indefinitely without paying any rent and without opening for business until the landlord satisfied the cotenancy condition. In a surprising outcome, ignoring the parties' negotiated lease terms, the Court ruled in favor of the landlord.

The landlord (Grand Prospect Partners) and tenant (Ross Dress For Less) negotiated the lease terms through counsel over the course of three years. During their negotiations, Ross insisted that the lease contain a cotenancy contingency requiring the other major tenants in the center, Mervyns and Target, to be operating their businesses in 76,000 square feet and in 126,000 square feet of leasable floor area, respectively, on the commencement date of the Ross lease. If this condition was not met, the cotenancy provision allowed Ross to possess its leased premises rent-free, regardless of whether it opened its own store for business. This was the rent abatement provision. Ross could continue to possess the property in this manner until Grand Prospect caused Mervyns, Target or alternate anchor tenants to open for business in the requisite amount of floor area. If Grand Prospect was unable to cure this situation for a period of 12 months following the lease commencement date, then at any time thereafter, but before Grand Prospect found a replacement cotenant, Ross could terminate the lease upon 30 days' notice.

Mervyns filed for bankruptcy protection shortly after Grand Prospect had completed the tenant improvements on the Ross premises and Ross had confirmed the date on which it would take possession of the leased premises. Consequently, the Mervyns store never opened for business.

Importantly, however, Mervyns owned its own building within the shopping center, so Grand Prospect had no control over Mervyns' continued occupancy or operations in the shopping center, or the re-leasing of that space.

Ross accepted delivery of its landlord-improved premises, but did not open for business or pay rent during the 13 months that it possessed the premises. During this time, Grand Prospect attempted unsuccessfully to abide by the cotenancy clause by acquiring the Mervyns building and leasing it to Kohl's. Twelve months after Ross took possession of its premises, Ross delivered its lease termination notice to Grand Prospect based upon Grand Prospect's inability to find a suitable replacement tenant for Mervyns.

Grand Prospect sued Ross. Grand Prospect, which had negotiated and signed the cotenancy clause, argued that the cotenancy provisions were unenforceable because they were "unconscionable" and served as "unenforceable penalties." As the parties were highly sophisticated, the lease terms were extensively negotiated and no coercion or other improper conduct could be attributed to either party, the appellate court did not find the cotenancy provisions unconscionable. Likewise, the appellate court determined that the clause allowing Ross to terminate the lease upon 30 days' written notice before Grand Prospect cured the cotenancy contingency was not a penalty. Clauses that allow a lease to be terminated upon the occurrence of certain contingencies generally are not penalties when inserted into commercial leases between sophisticated parties and the conditions bear no relation to any act or default of either party. Neither Grand Prospect nor Ross had control over whether Mervyns remained in its building or opened for business, or over whether the Mervyns building would be occupied by the type of anchor tenant specified in the lease. Hence, the termination provision was valid because it had no relation to any act or default of the parties.

Surprisingly, though, in a first to our knowledge, the court determined that the rent abatement provision acted as an "unenforceable penalty" on the landlord, and that Ross owed Grand Prospect rent for the 13 months during which Ross possessed the leased premises (even though it never opened its store). The court explained that regardless of whether the parties had labeled this provision as a liquidated damages provision, a rent abatement provision, or any other type of provision, it would have been deemed an unenforceable penalty.

A lease provision is a penalty, and is therefore void, when it requires a landlord to forfeit money

or property without regard to the amount of damage that, at the time the parties negotiate the agreement, a tenant anticipates it might suffer due to the landlord's noncompliance with that provision. The Ross rent abatement clause amounted to a penalty because the \$39,500 per month in rent that Grand Prospect lost due to Mervyns' bankruptcy bore no reasonable relationship to the \$0.00 in harm Ross anticipated it would suffer from the lack of an operational Mervyns or from Ross's inability to open and operate a store in this location. Here, the balance between an outcome in favor of the tenant and one in favor of the landlord, was decided in favor of the landlord because the landlord had no control over whether Mervyns occupied or operated its business in the adjacent property. [You could question why the landlord ever agreed to a cotenancy clause involving another owner's property, but we assume the landlord knew what it was doing and took a calculated risk]. In a another factor that might have swayed the court to ignore the contractual provisions, the court noted that the landlord had paid for over \$2,300,000 in tenant improvements before Ross took possession of the leased premises.

A case with different facts might have resulted in a verdict favoring the tenant and I think we can anticipate Ross appealing this decision to the California Supreme Court. To be enforceable, the amount of rent withheld under a cotenancy rent abatement provision must be reasonably related to the lost sales, lost profits, or other damage a tenant anticipates it might suffer if the required cotenant does not occupy or open for business in the requisite amount of adjacent space. Parties should also consider whether the landlord owns the cotenant's premises or otherwise exercises any control over whether the necessary cotenant remains in the requisite premises or opens for business within the agreed-upon time frame. To avoid this situation, which is essentially pushing back on Ross because it went over the "hogline," keep these guidelines in mind when negotiating a cotenancy clause. If the Supreme Court takes the case, we will report at a later time on the eventual outcome.