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One of Prime Minister Justin Trudeau's signature election promises was the legalization of marijuana across Canada. After eighteen months, his government has finally announced that it will be

# Co-Tenancy, Exclusive Use and Prohibited Use: Negotiation Tips for Both Landlords and Tenants

*Rick Thomas and Zach Siegel*

Co-tenancy, exclusive use and prohibited use provisions are frequently the most difficult, time-consuming and frustrating provisions to negotiate in retail leases. On the one hand, a tenant may demand express remedies (e.g., liquidated damages in the form of rent credits and rent abatements as well as termination rights) for violations of rights it views as material to its operations. On the other hand, a landlord may seek to protect its primary interest in every lease (i.e., its future revenue stream).

These competing desires are the main factor that makes the negotiation of these provisions so problematic. This article attempts to provide strategies for both landlords and tenants to reach compromise on these issues quickly as well as to provide some explanation of each party's concerns so that provisions can be crafted that are mutually beneficial.

**Co-Tenancy Provisions**

A co-tenancy provision grants a tenant certain remedies when a portion of leasable space at the shopping center is not open for business. Landlords and tenants can craft co-tenancies that are specific to another tenant, a group of tenants or a certain percentage of square footage within a designated area at the shopping center. Tenant remedies triggered by a co-tenancy failure commonly include the right to delay opening, cease operations, pay no rent or reduced rent, or terminate the lease if the condition continues for a certain period of time. Tenants push for the inclusion of co-tenancy provisions in leases to provide some security that desirable operators will drive traffic to the shopping center. Landlords, however, are concerned that co-tenancy provisions may be triggered by events that are outside their control. For example, Macy's, once considered a premier co-tenant capable of driving significant traffic to a shopping center, announced in January 2017 that it is closing 63 stores nationwide.[1] This type of co-tenancy failure can have serious ramifications for a landlord's revenue stream because the breach of a single co-tenancy could cause a domino effect by triggering a series of other closures or terminations at the shopping center.

*Sunsets and Recapture Rights*. One drafting strategy landlords can employ to mitigate the risks associated with a co-tenancy failure is to impose sunsets on remedies. For example, if a tenant has the right to pay reduced rent and to terminate the lease due to a co-tenancy failure, then the landlord could require that the tenant terminate the lease by a specific deadline (typically 12 to 24 months after the violation begins), or waive such termination right and commence paying full rent. After the deadline, the landlord will either receive the space back (with the ability to lease it to a tenant that will pay full rent or at least more than the reduced rent paid by the existing tenant), or the tenant will again become obligated to pay full rent.

A tenant that is willing to agree to a sunset is advised to request reimbursement from the landlord for the unamortized cost of its build-out in the event it chooses to terminate the lease by the sunset deadline. The tenant's argument is that the reduced rent it paid was to compensate the tenant for the co-tenancy failure. Further, by forcing the tenant to choose between termination and paying full rent, the landlord should be obligated to return the tenant to its original position by reimbursing the tenant for its costs in constructing the premises, which it intended to occupy for the entirety of the term.

A distinction should also be made between "ongoing co-tenancies" and "opening co-tenancies." An ongoing co-tenancy is a provision that lasts for the duration of the lease. Typically, if the co-tenancy condition specified in the lease is not satisfied for a specific period of time (e.g., between 120 days to 365 days), then the tenant's rights are triggered. This differs from an opening co-tenancy, which only applies on the date on which the tenant is required to open for business in the leased premises. After the opening co-tenancy condition is satisfied, its terms are null and void and cease to apply. A landlord may be less likely to require a sunset for an opening co-tenancy, as (especially in the context of an existing development) it generally has confidence that a specific tenant, or groups of tenants, will be open and operating at the date the applicable tenant is scheduled to open. Landlords do not have this same confidence when it comes to ongoing co-tenancies, as the potential closure of even the strongest named co-tenant (e.g., Macy's) increases over time and is not within the landlord's control.

An alternative drafting strategy landlords may employ to mitigate the risk of a co-tenancy failure is to include a right to recapture the premises during the co-tenancy failure period. Tenants willing to accept a recapture right are advised to include in the lease the right of the tenant to nullify the landlord's recapture right by agreeing to resume paying full rent and waive its termination right. On balance, the mechanics of a recapture right are likely better for the tenant because the landlord is the party that must act to terminate the lease, and if it does not do so, the right to pay alternate rent continues in effect. Additionally, this period has the potential to extend beyond the normal deadline established under a sunset provision because a landlord is not likely to exercise its recapture right until it has found a replacement tenant for the space (which may be a difficult task in light of the co-tenancy failure and the tenant's right to nullify recapture, which functions as a deterrent for negotiations similar to a right of first refusal).

*Replacement Rights*. Another strategy for landlords is to negotiate for the right to replace named co-tenants with replacements. While landlords will negotiate for broad replacement rights (i.e., replacing a named co-tenant with one or several other tenants without limitations on the type of operators), tenants try to limit what constitutes a suitable replacement. Some tenants may even request the right to approve the replacement, which essentially abrogates the landlord's right to replace the named co-tenant.

As a middle ground, the parties can define what constitutes an appropriate replacement either by: (1) broadly defining the type of national or regional retailer that qualifies (using criteria such as the number of the operator's locations and the line of business) or (2) including in the lease a list that identifies specific retailers by name that qualify as replacements. If the landlord and tenant agree on the latter approach, landlords are advised to include language allowing for replacement tenants that are similar to those on the enumerated list to account for new concepts and changes in retailers' operations after the date of the lease.

**Exclusive Uses**

An exclusive-use provision grants a tenant the sole right to conduct a certain type of business within a designated area of the shopping center, subject to negotiated exceptions. When an exclusive use is violated, the tenant may be granted the right to pay reduced rent. (Common formulations include reduced rent of 2-4 percent of gross sales, capped at what otherwise would have been payable as monthly rent, or 50 percent of base rent.) Additionally, if the violation is not remedied within a certain period, a tenant may be granted the right to terminate the lease.

*Negotiating Definitions*. The primary consideration for landlords in negotiating exclusive uses is to craft the scope of the "exclusive use" narrowly. Consider, for instance, a tenant that requests the exclusive right to sell "salad as its primary business." Although this exclusive use might seem straightforward, a deeper look reveals ambiguities. *Merriam-Webster's Dictionary* defines "salad" as: "1. a mixture of raw green vegetables (such as different types of lettuce) usually combined with other raw vegetables; 2. a mixture of small pieces of raw or cooked food (such as pasta, meat, fruit, eggs or vegetables) combined usually with a dressing and served cold." A court may find that the broad scope of this definition includes a variety of food items that were not intended to be part of the exclusive-use right. For instance, a Southwestern rice bowl served with chicken, salsa and vegetables could be included in this definition of "salad"—something the landlord and its counsel would likely want to exclude from the exclusive use definition.

Furthermore, what does "primary business" mean? Does it mean that the operator sells more salads than anything else? Or does it mean that more than half of what the operator sells constitutes salad? And even if the landlord and tenant agree on one of the above, how do you measure how much an operator sells? Is it based on gross sales at the applicable location, or at all locations? Alternatively, should the determination be based on the number of menu items rather than gross sales?

Landlords and tenants are advised to pay close attention to the scope of an exclusive during negotiation and drafting. By narrowly defining the scope of the exclusive use, landlords can mitigate significant risk by limiting the potential for future disagreement and violations of an exclusive-use provision. Not only does avoiding ambiguity mitigate risk for the landlord, it will assist the landlord in future leasing efforts, as prospective tenants will have an easier time reviewing and understanding the exclusive provisions of other tenants to determine whether it can comply with such restrictions.

*Negotiating the Entity to Whom the Exclusive Applies*. It is imperative for a landlord to carve out tenants under existing leases from those parties that are subject to an exclusive-use restriction, as the landlord could not have included the restriction in previously executed leases.[2]

This should not be a controversial point for the tenant. However, it is common and reasonable for a tenant to request a list of the existing leases to be included as a schedule to the lease so that the tenant has a record of

those leases that are not subject to its exclusive.

Finally, it is common for anchor tenants to be excluded from the restriction.[3] As a practical matter, many anchor tenants and some junior anchor tenants will refuse to be subject to any exclusive-use restrictions. Tenants may find this problematic if it perceives anchors and junior anchors as competitors. But, similar to a tenant's argument in favor of a co-tenancy requirement, landlords should note that anchor tenants benefit all occupants by driving traffic to the shopping center and, therefore, landlords should not be required to impose such restrictions on these types of retailers. Indeed, it is especially difficult for an inline tenant to argue that an anchor tenant should be subject to its exclusive if such an anchor is required to satisfy a co-tenancy requirement in the lease.

*Negotiating Remedies*. Landlords can also mitigate risk by negotiating the remedies available to a tenant in the event of an exclusive-use violation. Again, the tenant will likely want the right to pay reduced rent or terminate the lease in the event the violation is not resolved within a certain period of time. One alternative to this resolution that a landlord can propose is to record a restrictive covenant against the property that is affected and make the tenant a third-party beneficiary. In such a situation, the tenant can seek an injunction for the violation and should not require liquidated damages and a termination right.

If the tenant is unwilling to accept this proposition, then the landlord may require a "rogue tenant" provision. A rogue tenant provision provides that the objecting tenant has no remedy for the violation if the lease for the violating tenant prohibits that tenant from operating in violation of the applicable exclusive use.

*Sunsets and Recapture Rights*. For the same reasons identified above in our discussion of co-tenancies, landlords should try to impose a sunset on a tenant's remedies or a recapture right for an exclusive-use violation. That said, an exclusive-use violation differs from a co-tenancy failure because it is a breach of a landlord covenant (i.e., the failure of the landlord to police the uses of other occupants at the shopping center), while a co-tenancy failure is a failure of a condition largely outside of the landlord's control.[4]

Accordingly, tenants strongly oppose any limitations on these remedies, arguing that protection against competing operations is a material inducement to the tenant entering into the lease. Additionally, tenants view a landlord's violation of an exclusive covenant either as an egregious error on the part of the landlord or an intentional violation of the lease based on a fairly simple economic calculation. (If the lease contains a sunset on remedies, it might make financial sense for the landlord to lease space in the shopping center to a competitor of the tenant even though this allows the tenant to pay alternate rent until the sunset deadline; thereafter, the landlord may re-lease the space if the tenant terminates its lease, especially if the tenant is paying below-market rents at that time). If the tenant fails to terminate, then it will be required to commence paying full rent, notwithstanding the fact that the shopping center now contains a competitor.

A landlord may be able to alleviate a tenant's concerns regarding the foregoing by either recording a memorandum of lease with the restriction or providing for the recordation of a restrictive covenant with the provision, which (1) may give the tenant the right to seek an injunction in addition to its express remedies and (2) will limit the ability of the landlord to lease to a competitor intentionally because a competitor will not likely lease space that is subject to such a restriction.[5]

**Prohibited Uses**

A prohibited-use provision is different from an exclusive-use provision in that the tenant's concern is not driven by a desire to prevent competition. Instead, the tenant wants to prohibit undesirable uses that detract from the character of the shopping center or that have other perceived negative impacts on the tenant's operations (e.g., an increased demand for parking). Like exclusive-use provisions, however, prohibited-use restrictions may trigger express tenant remedies and also constrain the landlord's ability to lease space in the shopping center.

*Negotiating Remedies*. Negotiation strategies concerning prohibited use violations are similar, but not identical, to those employed in the context of exclusive uses. The biggest difference is that the perceived damages associated with a violation of a prohibited-use provision are more difficult to prove. For example, it is more difficult to show that an undesirable use in the center, such as an office use, damages the tenant in the same way that a direct competitor does. On the one hand, a landlord may be successful in limiting the tenant's remedies to actual damages or the right to seek an injunction. On the other hand, sophisticated tenants, understanding that it may be difficult to prove damages or obtain an injunction, may insist upon having express remedies such as the right to pay reduced rent and to terminate the lease. If this is the case, landlords are advised to negotiate the list of prohibited uses to reduce the risk of a violation as much as possible. If there are still concerns, the parties can bifurcate the list into two categories: (1) those that are of the most concern to the tenant (and which the landlord will be less likely to

violate), which entitle it to the express remedies of the right to pay alternate rent, and (2) those for which the tenant must prove damages or seek an injunction.

*Sunsets and Recapture Rights*. While a landlord may not be successful in obtaining a sunset or recapture right for an exclusive use, it should be able to obtain one for a prohibited-use violation. Indeed, it is less common for a tenant to have express remedies for a prohibited-use violation, and if such a remedy is granted, it is more reasonable to include a sunset or recapture right.

*Negotiating Carve-Outs and Exceptions*. Prohibited-use restrictions, including those derived from form lists provided by large national brands, are frequently extensive and often overly broad. Long lists grow into regimes that are complicated and costly to administer.[6] Perhaps more a concern from a business perspective, restrictions once considered standard are frequently incompatible with modern leasing trends and market developments.

As a threshold matter, as with exclusive-use provisions, landlords should seek to exclude the application of prohibited-use provisions from existing leases and anchor tenant leases. Additionally, landlords are advised to include reasonable carve-outs to the standard prohibited-use restrictions many tenants request. If carefully crafted, these exceptions mitigate tenants' concerns regarding certain uses, while maintaining flexibility for landlords to adapt to market trends in future leasing at the shopping center.

Consider, for instance, the prohibition of "any non-retail purpose," which appears in many lists promulgated by tenants. Landlords are advised to include exceptions for offices incidental to retailing, service retail, banks and small loan offices, and other similar operations. Landlords should also consider whether to retain the right to lease certain portions of the shopping center to nontraditional occupants of retail centers, since traditional retail operators are making way for other types of tenants, including office, medical and entertainment operators.

**Conclusion**

The issues explored in this article have the potential to complicate and delay lease negotiations. But, armed with a better understanding of its counterpart's objectives, a landlord and a tenant can each craft provisions that are specifically tailored to address the other's concerns while making fewer unnecessary concessions. Well-drafted provisions are especially important in the context of express remedies, which are at the heart of each party's risk assessment when it enters into the transaction. Using the negotiation and drafting strategies explored in this article, landlords and tenants can limit the risks associated with co-tenancy, exclusive-use and prohibited-use provisions and expedite negotiations for the benefit of all parties involved.

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[1] See www.businessinsider.com/list-of-macys-stores-closing-2017-1.

[2] Note that the carve-out should be written to exclude "tenants under existing leases," as opposed to "existing tenants," to account for assignments and subleases under existing leases. As a practice pointer, verbatim exclusives should always be used without modification in other leases. The discussion above regarding the importance of definitions should highlight why this is a best practice.

[3] Negotiations in this area generally focus on what constitutes an anchor tenant.

[4] As explored above, a co-tenancy failure is the breach of a condition precedent (in the case of an opening co-tenancy) or condition subsequent (in the case of an ongoing co-tenancy) largely outside of the control of the landlord.

[5] Obviously, this argument assumes that the competitor tenant will perform due diligence and discover the restriction.

[6] As discussed above, it is a best practice to include verbatim excerpts of prohibitions in the leases to which they apply. The more prohibitions granted by landlords, the longer this list becomes, and it becomes an administrative burden and intimidating for prospective tenants.