

# Co-Tenancy Clause Survives Challenge Before California High Court

By Joseph P. Heins and Jocelyn C. Ng

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The Supreme Court of California recently upheld the validity of the co-tenancy clause of a retail lease and its alternative rent structure in *JJD-HOV Elk Grove, LLC v. Jo-Ann Stores, LLC*, No. S275843, 2024 WL 5164746 (Cal. Dec. 19, 2024), determining that the landlord held the requisite control under the associated lease agreement with the co-tenant because that co-tenant was located on property owned by that landlord.

Notably, the court made a clear distinction between that scenario and the situation where a co-tenant is located on property owned by an unrelated third party.

In that case, the court left open the possibility that a co-tenancy clause could be unenforceable because the landlord does not have sufficient power or control over the terms of the associated co-tenant lease.

## Co-Tenancy Clauses Explained

A co-tenancy provision is most commonly found in leases for retail properties, and is designed to protect a retailer in the event an unacceptable number of the other tenants in the shopping center close their doors. Retail tenants thrive on high traffic within shopping centers and can be harmed when that traffic drops due to the closure of other operators.



A co-tenancy provision provides a tenant with certain remedies in the event that the occupancy of a shopping center falls below predetermined thresholds. The thresholds are typically either a specified number of named or anchor tenants or a certain percentage of the gross leasable area of the shopping center.

In the event that those named tenants close, or the shopping center vacancy rate exceeds the agreed-upon percentage, the tenant under the lease would be entitled to exercise its remedies. Importantly for the case at hand, the other retailers that determine this threshold are not always tenants of the subject landlord; instead, they may

occupy property owned by another landlord, but is still within one cohesive shopping center.

Generally speaking, there are two types of co-tenancy clauses: opening co-tenancy and operating (or on-going) co-tenancy. Opening co-tenancy clauses provide that a tenant will not be required to open its store or begin paying rent unless and until an occupancy threshold is met.

Opening co-tenancy clauses are commonly used in leases signed during the construction or development of a shopping center, or when an existing shopping center is undergoing a renovation or redevelopment.

On the other hand, operating co-tenancy clauses apply after a tenant initially opens in its space. In this scenario, should the shopping center fall below the agreed-upon occupancy thresholds during the term of the lease, the tenant's remedies kick in. Remedies typically include some form of reduced rent and, potentially, a right to terminate the lease.

#### ***JJD-HOV Elk Grove, LLC v. Jo-Ann Stores, LLC***

In this particular case, Jo-Ann Stores, LLC (Jo-Ann) leased approximately 35,000 square feet in a shopping center owned by JJD-HOV Elk Grove, LLC (JJD).

The co-tenancy clause in this lease stated (in part): "To induce Tenant to enter into this Lease ... Landlord represents that it has entered into or shall enter into binding leases ... for the use and occupancy of either: (x) [three so-called 'anchor tenants' or comparable substitutes] ... or (y) sixty percent (60%) or more of the gross leasable area of the Shopping Center (excluding the Premises)."

In the event of a co-tenancy violation, Jo-Ann was entitled to terminate the lease or, in lieu of base rent, to pay "Substitute Rent" equal to the greater of: (i) three and one-half percent (3.5%) of its gross sales or (ii) \$12,000.00 per month. To provide perspective as to the severity of the remedy, JoAnn's monthly rent at the time of the co-tenancy violation was \$42,292.00.

There was no dispute about whether a co-tenancy violation occurred; instead, the question

at issue in this case was whether the co-tenancy provision should be evaluated under an alternative performance rubric or as a liquidated damages provision.

If the court were to decide that the co-tenancy provision should be evaluated pursuant to liquidated damages principles, the court could then declare the remedy void as an unenforceable penalty. Instead, the court determined that it should be evaluated as a form of alternative performance, meaning any such inquiry ended and the provision was declared valid.

The court quoted *McGuire v. More-Gas Investments, LLC*, 163 Cal. Rptr. 3d 225, 235 (Cal. Ct. App. 2013), which succinctly summarized the distinction between the alternative performance and liquidated damages approaches as follows:

"Where 'the contract clearly reserves to the owner the power to make a realistic and rational choice in the future with respect to the subject matter of the contract,' a valid alternative performance provision will be found.

On the other hand, where the 'arrangement, viewed from the time of making the contract, realistically contemplates no element of free rational choice on the part of the obligor insofar as his performance is concerned ...,' the provision will be deemed to provide for a penalty."

The court then ruled that the co-tenancy provision at issue fit into the established alternative performance framework. To quote: "The cotenancy provision 'clearly reserves to [JJD] the power to make a realistic and rational choice.'" *JJD-HOV Elk Grove*, 2024 WL 5164746, at \*5 (quoting *Blank v. Borden*, 524 P.2d 127, 131 (Cal. 1974)).

"JJD can choose to provide a higher level of service (i.e., a mall with anchor tenants or specified occupancy levels) and receive a higher rental amount or, alternatively, to provide a reduced level of service (i.e., a mall with reduced anchor tenants or occupancy levels) and receive a reduced rental amount."

The court noted that while a tenant's departure from the shopping center is not an affirmative

action taken by JJD, JJD retained control over the property at issue and had the ability to satisfy the co-tenancy clause.

“If JJD wishes to avoid receiving a lower level of rent, it can choose to make inducements to attract additional anchor tenants or raise the overall occupancy rate. These efforts may include offering favorable lease terms, providing additional amenities to tenants, or renegotiating important leases.”

A prior case in California, *Grand Prospect Partners, L.P. v. Ross Dress for Less, Inc.*, 182 Cal. Rptr. 3d 235 (Cal. Ct. App. 2015), *as modified on denial of reh'g* (Cal. Ct. App. 2015), had come to the opposite conclusion, and the co-tenancy provision at issue was determined to be an unenforceable liquidated damages penalty.

In *Grand Prospect*, the co-tenancy clause required that Mervyn's (an anchor tenant on an adjacent parcel) remain open, even though the landlord did not own or control the Mervyn's parcel (Mervyn's owned its real estate in fee).

That court determined that Grand Prospect did not have the power or control necessary to make a realistic choice regarding its performance under the co-tenancy clause because it did not own the Mervyn's parcel and was not a party to a lease with Mervyn's.

The implications of the contract were instead triggered solely by a third party, and Grand Prospect was powerless to change that outcome. The court in *JJD-HOV Elk Grove* distinguished this prior case because JJD, as owner of the shopping center, retained the control that Grand Prospect did not – namely, to induce the existing tenants to stay or find a suitable replacement for them.

Landlords and tenants alike should note that the courts in both *Grand Prospect* and *JJD-HOV Elk Grove* left open the possibility that, despite the existence of a written lease negotiated between

two sophisticated parties, a co-tenancy provision could be deemed unenforceable and void, depending on how the provision is structured and the amount of control retained by the landlord.

As always, lease drafting will be key to avoiding such unintended consequences and ensuring that a co-tenancy provision and any alternative rent structures remain enforceable. Under the *Grand Prospect* and *JJD-HOV Elk Grove* standard established by the California Supreme Court, the threshold question will be whether a landlord owns the property or otherwise has control or power under the leases with the required tenants under a co-tenancy provision.

If the answer is yes, then there is no need to deviate from past drafting procedures. However, there are often multiple owners of a single retail shopping center - for example, in *Grand Prospect*, the anchor tenant owned its own property and a portion of the adjacent parking area, and the landlord owned the remainder of the shopping center.

In that case, the landlord does not hold the requisite power or control under *Grand Prospect* and *JJD-HOV Elk Grove*, and the tenant's attorney must take special care to ensure that their client's remedies under the co-tenancy clause remain valid. Crucially, the provision must be structured so that it qualifies under the alternative performance framework, rather than as liquidated damages.

This is a changing area of the law and best practices for drafting are still developing, but it is clear that co-tenancy provisions now require a heightened level of scrutiny.

**Joseph P. Heins**, *special counsel and member of Phillips Lytle's Real Estate Industry Team*, focuses his practice on commercial real estate and complex transactions. **Jocelyn C. Ng** is an attorney and member of Phillips Lytle's Real Estate Industry Team.