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Cotenancy Provisions: Enforceable Lease Provisions or Unenforceable Penalties?

In *JJD-HOV Elk Grove, LLC v. Jo-Ann Stores, LLC*, the California Supreme Court recently held that cotenancy provisions can be enforceable and not unreasonable penalties precluded by California's liquidated damages statutes. Cotenancy provisions "typically allow retailers to pay reduced rent or terminate the lease when the number of anchor tenants (large retailers that are attractive to a broad range of shoppers) or the overall occupancy level of retailers in a shopping center falls below a specific threshold."^[1] In expressing a reluctance to disrupt negotiated contractual terms between sophisticated parties, the Supreme Court held that the cotenancy provision was not a penalty because it provided the landlord with a rational choice between two reasonable alternatives: (1) ensure the continued presence of "anchor tenants" to receive full rent from the other retailers who have the cotenancy provision in their respective leases, or (2) allow occupancy to fall below that threshold or allow anchor tenants to leave, and receive the agreed-upon reduced rent or even termination of the other retailers' leases.

The California Supreme Court makes clear that the key factor in determining whether a cotenancy provision provides for a mechanism of alternative performance is whether the landlord has a "realistic and rational choice" between the alternative performances of the agreement.^[2] Necessarily, this determination requires an analysis of the landlord's level of control over which method of performance to pursue.

As a preliminary matter, cotenancy provisions are mostly found in commercial retail leases and benefit the tenants of malls and shopping centers by protecting against the volatility caused by the departures of their cotenants, especially anchor cotenants. The closure of a retailer with substantial customer draw in such a localized ecosystem often results in a diminution in customer traffic that harms the remaining tenants. Their business drops, and their leases become less valuable. To compensate, cotenancy provisions will generally allow a tenant to pay reduced rent or terminate a lease should an anchor tenant vacate the center, or should the general tenant occupancy fall below a bargained-for threshold.

In this particular case, the issue was precipitated by a tenant's exercise of the cotenancy provision in its retail lease and its landlord's subsequent displeasure with a term it freely bargained for. In September 2004, JJD-HOV Elk Grove, LLC, a landlord and owner of a shopping center in Elk Grove, California, and Jo-Ann Stores, LLC, a national craft chain store, entered into a lease for approximately 35,000 square feet of retail space in the Elk Grove shopping center. The lease provided for two different calculations of rent: a "Fixed Minimum Rent" of \$36,458 (subject to increase every 5 years), and a "Substitute Rent" of the greater of three and one-half percent of Jo-Ann's sales or \$12,000 a month. The Substitute Rent would be triggered by the landlord's failure to abide by a cotenancy provision.

Over the course of the lease, Jo-Ann invoked the cotenancy provision three times: once in 2004 before the three anchor tenants opened for business (open businesses being a requirement under the lease), once in 2007 after an anchor tenant was replaced with a business that Jo-Ann deemed incomparable, and again in 2018 following the departure of two anchor tenants from the shopping center—Sports Chalet and Toys "R" Us. On the third time, Jo-Ann paid the Substitute Rent for approximately twenty months until May 2020, until another store opened in the former Toys "R" Us space.

Following Jo-Ann's third invocation of the cotenancy provision, the landlord brought suit for over \$600,000 of allegedly unpaid rent, relying primarily on the 2015 *Grand Prospect* opinion of the California Court of Appeal affirming a trial court judgment determining that a cotenancy provision allowing for a rent abatement due to an anchor tenant's closure operated as an unenforceable penalty.^[3] On the landlord's and Jo-Ann's cross-motions for summary judgment, the trial court ruled in Jo-Ann's favor that the co-tenancy clause of the parties' lease provided for an alternate rent structure, not a penalty.^[4] The Court of Appeal affirmed, and the Supreme Court granted the landlord's petition for review. ^[5]

First, the Supreme Court determined whether Jo-Ann's rent abatement was an alternative performance under the lease or a liquidated damages clause—which would open the door to it being an unenforceable penalty. The Court undertook a two-part inquiry. First, the Court determined whether the cotenancy provision *actually* provided for methods of alternative performance, *i.e.*, did the clause contemplate a credible, realistic and rational choice on the part of the landlord obligor.^[6] If so, alternative performance exists and the inquiry ends. If not, the Court would then analyze the reasonableness of the liquidated damages clause.

The Supreme Court determined on the first step that the parties' cotenancy provision provided the landlord with sufficient choice to pursue alternative performances under the lease. Specifically, it reasoned that "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."^[7] The Court thus based its decision on an analysis of the landlord's ability to choose between receiving the full agreed-upon rate (by increasing the number of anchor tenants and improving occupancy rates through financial inducements, favorable lease terms, or additional amenities, for example) on the one hand, and receiving a reduced rent (by providing reduced levels of service and reduced value to its retail tenants) on the other hand.

In this vein, the Supreme Court rejected the landlord's argument that it lacked any control of the actions of the anchor tenants who were third parties to the lease, and that the actions of those third parties could not serve as a condition precedent to Jo-Ann's rent abatement. The Supreme Court pointed to the landlord's retention of at least some level of control over occupancy rates of the shopping center through its ability to attract and incentivize prospective tenants and maintain its existing tenants—or simply to *choose* to accept the lower rent to which it agreed.^[8]

Finally, the Supreme Court distinguished the matter at hand from the landlord's *Grand Prospect* authority by noting that the *Grand Prospect* landlord lacked the relevant control over its anchor tenants and property at the time the lease was made: the *Grand Prospect* landlord did not own the space nor have any opportunity to affect the anchor tenant's decision to cease operations when entering into the lease. As a result, it did not have the same rational and realistic choice between alternate performances.

While *JJD-HOV Elk Grove, LLC v. Jo-Ann Stores, LLC* provides valuable clarification, it doesn't establish a rigid, inflexible rule. It's clear that commercial landlords should be prepared to fulfill their obligations under cotenancy clauses, especially when these clauses offer the landlord flexibility in how to meet their lease commitments.

[1] *JJD-HOV Elk Grove, LLC v. Jo-Ann Stores, LLC* (2024) 17 Cal. 5th 256, 298-9.

[2] *Id.* at 302.

[3] *Grand Prospect Partners, L.P. v. Ross Dress for Less, Inc.* (2015) 232 Cal. App. 4th 1332, 1365.

[4] "[T]he Lease's co-tenancy provisions in Section 15 and 2(u) do not reflect 'damages' but instead reflect terms for a different rent structure in the event certain contingencies occur. In short, the Court finds that . . . Sections 15 and 2(u) of the Lease are valid and enforceable and that [Jo-Ann] is current in payments to JJD by payment of Substituted Rent when permitted to do so under the Lease[.]" *JJD-HOV Elk Grove LLC v. Jo-Ann Stores, LLC* (Cal.Super. Apr. 26, 2021) No. 34-2019-00248163, 2021 WL 9583626, at *6.

[5] *JJD-HOV Elk Grove v. Jo-Ann Stores* (Cal. 2022) 517 P.3d 1156; *JJD-HOV Elk Grove, LLC v. Jo-Ann Stores, LLC* (2024) 80 Cal. App. 5th 409, 426.

[6] *Blank v. Borden* (1974) 11 Cal. 3d 963, 970.

[7] *JJD-HOV Elk Grove, LLC v. Jo-Ann Stores, LLC* (Cal. Dec. 19, 2024) No. S275843, 2024 WL 5164746, at *5.

[8] The lease with Jo-Ann expressly qualified its co-tenancy clause as made to "induce Tenant to enter into this Lease[.]"

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