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California Supreme Court Decides Cotenancy Provisions Are Here to Stay

On December 19, 2024, the Supreme Court of California passed down a unanimous decision in a lawsuit closely watched by commercial real estate landlords and retail tenants that involved the validity of so-called cotenancy provisions in commercial real estate leases under California contract law. The decision affirmed earlier trial and appellate court decisions and addressed a split in how California courts have determined the enforceability of lease cotenancy provisions.

Cotenancy provisions allow retailer tenants in a shopping center or mall to reduce their rent or outright cancel leases when the property's overall occupancy level falls below a specific threshold or in the event that a major, "anchor" retailer exits the property. These provisions are widely used as they limit a tenant's exposure to events that could impact its retail presence, while providing landlords a bargaining chip in attracting strong retailers to their commercial properties.

The inclusion and scope of cotenancy provisions are the product of negotiation between landlord and tenant and are creatures of state contract law. As the recent decision noted, courts are reticent to intervene in such contracts, or as the Court stated it, "contracts should be enforced as written and agreed upon by the parties," but there are exceptions to this general principle, such as Section 1671 of the California Civil Code, which prohibits the enforcement of liquidated damages provisions when they operate as unreasonable penalties for contractual breach. The case before the Court contemplated whether cotenancy provisions are subject to Section 1671, or in effect, whether such provisions are enforceable under California law.

The case under review involved the 10-year lease of a 35,000 square foot space by a national fabric and craft chain store in a shopping center located in Elk Grove, California. The lease agreement held a cotenancy provision and a

reduction in rent triggered by either the closure of anchor tenants or if the shopping center's occupancy fell below 60%. This latter condition was the trigger at the heart of the case. After a lengthy duration of paying reduced rent premised on the lease's cotenancy provision, the retail tenant was sued by its landlord, who claimed that the cotenancy provision was unenforceable and demanded over \$600,000 plus interest.

Notably, this was the third instance that the tenant paid reduced rent during the lease term pursuant to the lease's cotenancy provision. The second instance led to litigation but was settled out of court; in neither prior instance did the landlord challenge the enforceability of the cotenancy provision.

The Court determined that the cotenancy provision was valid and should be interpreted as a form of alternative performance (rather than a breach) and that neither Section 1671 nor Section 3275—which concerns to forfeiture in response to a contractual breach—applied in this instance. Given this, the Court concluded that “traditional contract interpretation norms govern, and the contract should be enforced as written.”

What this means to you

The ruling preserves cotenancy provisions as a valid and enforceable part of commercial real estate leases in California; however, it also highlights the complexities involved in such provisions, both in terms of the provisions' risk allocation strategies as well as the statutory limitations of such provisions. Given this level of complexity, both landlords and tenants should seek out experienced legal counsel in order to limit risk and to reach agreements that withstand scrutiny in the litigation setting and that hold a degree of predictability for the landlord-tenant relationship.

Contact us

If you have questions regarding this decision or concerning cotenancy provisions generally, please contact Mhare Mouradian, MaryBeth Heydt, or your Husch Blackwell lawyer.