

# California Supreme Court upholds cotenancy clause in retail lease as providing alternative rent structure

By Mark Johnson, Esq., and Bessie Fakhri, Esq., Seyfarth Shaw LLP

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Cotenancy clauses afford rent relief where another key tenant in a retail center ceases operating. They typically provide that a tenant is not obligated to pay full base rent, but rather some form of alternative rent amount (e.g., at a reduced rate or based on a percentage of actual sales) when specified anchor tenants or a percentage of key tenants are not open and operating, or when a minimum gross leasable area in a shopping center is not open.

The rationale is that anchor tenants benefit all tenants by driving foot-traffic to the center such that when anchor tenants are not operating, a corresponding reduction in rent is appropriate.

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Frequently, landlords seek to avoid the effect of such clauses by arguing that they are tantamount to a liquidated damages provision, and invoke the defense that their impact serves as an unenforceable damages penalty. Retail tenants typically counter that cotenancy clauses serve a completely different purpose than liquidated damages provisions, which implicate a breach of contract by landlords. Rather, tenants argue, cotenancy provisions simply serve as an alternative form of rent structure — for when the cotenancy is met and when it is not met.

In a recent opinion, California’s highest court held that a cotenancy provision in a retail shopping center lease was enforceable because it merely provided for an alternative method of performance in the form of reduced rent when a cotenancy failure occurs, rejecting the landlord’s argument that the provision constituted an unenforceable liquidated damages penalty. *JJD-HOV Elk Grove v. Jo-Ann Stores*, 17 Cal.5th 256, 560 P.3d 297, 328 Cal.Rprt.3d 61 (Cal. 2024).

This case has important implications for not only California retail landlords and tenants, but more broadly for parties throughout the country given the prevalence of cotenancy provisions in retail leases.

## Cotenancy clauses

Citing various treatises, the California Supreme Court explained that “[c]otenancy clauses condition a retail tenant’s opening or operating of its business on whether other tenant businesses in a specific shopping center are also open for business.” *JJD-HOV*, 17 Cal.5th at 260, 560 P.3d at 299, 328 Cal.Rprt.3d at 63. These clauses “provide the tenant with the option to pay reduced rent, or occasionally to terminate the lease, should the provision’s specified tenancy levels for the shopping center not be met.” *Id.*

The court noted that even if “[l]andlords do not usually control the events that lead to vacancies within shopping centers and therefore resist being bound by cotenancy requirements,” a ‘knowledgeable tenant may request that a landlord incorporate the clause’ into the lease to protect a tenant’s financial viability should the shopping center not be utilized to its full capacity.” *Id.*, quoting *Thompson on Real Property*, Thomas eds (2024), § 44.14(b)(1).

The reality is that when anchor tenants have closed and their space sits empty, it affects foot-traffic to the shopping center generally, and to a retail tenant specifically. “No retail tenant wants to be stuck in a shopping center filled with vacant stores.” *Id.*, Cal.5th at 266, 560 P.3d at 303, 328 Cal.Rprt.3d at 68, quoting *Thompson on Real Property*, § 44.14(b)(1).

The California Supreme Court reasoned that “anchor tenants greatly impact the economic viability of other retail tenants in a shopping center by attracting customers.” *Id.*, Cal.5th at 260, 560 P.3d at 299, 328 Cal.Rprt.3d at 63. “Cotenancy provisions assure a retail tenant that other tenants and, in particular, anchor tenants, will be open for businesses.” *Id.*

The court observed that these provisions “are typically a result of extended negotiations between a landlord and tenant, who tend to be sophisticated and well-represented.” *Id.* Cotenancy provisions generally include the following provisions: (1) specific named cotenants and occupancy levels, (2) any right the landlord has to cure a failure to satisfy a cotenancy provision, and (3) any remedies the tenant has should a cotenancy provision not be satisfied. *Id.*

## The parties' lease

In *JJD*, the landlord entered into a retail lease with Jo-Ann, a national fabric and craft chain store, consisting of approximately 35,000 square feet of space in the shopping center. The lease provided two different calculations of rent: Fixed Minimum Rent or Substitute Rent (which was a percentage of gross sales). *Id.*, 17 Cal.5th at 262, 560 P.3d at 300, 328 Cal.Rprt.3d at 64-65.

The lease contained a cotenancy provision, which included landlord JJD's representation that it would enter into leases for the occupancy of (a) three anchor tenants, or comparable substitutes, or (b) 60% or more of the gross leasable area of the shopping center. *Id.* The provision required the cotenants to be open for business. *Id.* If the cotenancy provision was not satisfied for a period of six months, Jo-Ann had the option of either paying substitute, reduced rent until the cotenancy requirement was met or to terminate the lease. *Id.*

Approximately 14 years after entering into the lease, two anchor tenants in the shopping center closed for business, reducing total occupancy in the center to below the 60% threshold, resulting in a failure in the cotenancy requirement. *Id.*, 17 Cal.5th at 263, 560 P.3d at 301, 328 Cal.Rprt.3d at 65. Jo-Ann thus notified JJD it would be paying substitute rent. *Id.*

JJD then brought suit against Jo-Ann, arguing that the cotenancy provision constituted an unenforceable penalty under section 1671 of the California Code of Civil Procedure. *Id.* Section 1671 governs liquidated damages clauses in contracts. Under 1671, liquidated damages provisions are presumptively valid, "unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made." Cal. Code Civ. P. § 1671(b).

The Court of Appeal below rejected JJD's argument, reasoning that the cotenancy provision and Jo-Ann's entitlement to pay substitute rent "was an alternative form of compliance with the lease as explicitly spelled out in the lease terms," rather than a contractual breach triggering analysis under section 1671. *JJD-HOV*, 17 Cal.5th at 264, 560 P.3d at 302, 328 Cal.Rprt.3d at 66, citing *JJD-HOV Elk Grove v. Jo-Ann Stores*, 80 Cal. App. 5th 409, 425 (2022). Indeed, cotenancy failures do not implicate a breach of lease by landlords, as landlords typically have no control over whether an anchor tenant ceases operations and have done nothing wrong to cause the vacancy in the first place.

The California Supreme Court agreed, ruling that the cotenancy provision was enforceable as written. The court explained that, in analyzing whether a contractual provision is an unenforceable penalty under section 1671, the court must "determine whether the provision substantively establishes methods of alternative performance or instead provides for liquidated damages." *Id.*, 17 Cal.5th at 265, 560 P.3d at 302, 328 Cal.Rprt.3d at 67. Where a provision reserves to an obligor "the power to make a realistic and rational choice," the provision will not be construed as a penalty. *Id.*

The *JJD* court found that the cotenancy provision in the Jo-Ann lease "fits into this established alternative performance framework." *Id.* Specifically, the court explained,

"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. Because tenants are receiving less value for the leases they are locked in to, it is reasonable for the parties to agree to lower rent payments for the reduced value of services." *Id.*

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That is, the cotenancy provision in *JJD* effectively reflected a variable rent scheme based on level of occupancy in the shopping center, rather than a liquidated damages clause occasioned by a breach by the landlord. *See id.*

## Takeaways

The *JJD* opinion is significant because it contains an extended analysis of the dichotomy between a cotenancy provision (which does not implicate a breach by the landlord) and a liquidated damages provision (which only arises when a landlord has committed a breach) and the resulting remedy, *i.e.*, an alternative form of rent payment or imposition of a liquidated damages award.

Also paramount is the court's observation that retail shopping center leases are typically entered into between sophisticated landlords and tenants, which "should be enforced as written and agreed upon by the parties." *Id.*, 17 Cal.5th at 261, 560 P.3d at 299, 328 Cal.Rprt.3d at 63. The *JJD* court ended its opinion by underscoring that, by their very nature, leases are allocations of risk between lessor and lessee. *Id.*, 7 Cal.5th at 272, 560 P.3d at 307, 328 Cal.Rprt.3d at 73.

Accordingly, "[t]he parties' contractual intent when reduced to writing should be controlling and enforced, particularly as applied to the commercial leasing market in arms-length negotiations and transactions." *Id.* This articulation of well-settled contract law proves a salient reminder for any landlord or tenant entering into a lease or contemplating legal action based on the parties' conduct under the provisions of a lease.

## About the authors



**Mark Johnson** (L) is a partner and **Bessie Fakhri** (R) is an associate at **Seyfarth Shaw LLP**, where Johnson serves as co-chair of the firm's real estate litigation group. The authors are based in Chicago and can be reached at [majohnson@seyfarthcom](mailto:majohnson@seyfarthcom) and [bfakhri@seyfarth.com](mailto:bfakhri@seyfarth.com).

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