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Supreme Court of California
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**IN THE SUPREME COURT
OF THE
STATE OF CALIFORNIA**

JJD-ELK GROVE, LLC

Plaintiff and Appellant,

v.

JO-ANN STORES, LLC

Defendant and Respondent.

On Review From The Court Of Appeal
For the Third Appellate District,
Division One, 3rd Civil No. C094190

After An Appeal From the
Superior Court For The State of California,
County of Sacramento, Case Number 34-201900248163,
Hon. Shama H. Mesiwala

PLAINTIFF-APPELLANT JJD-HOV ELK GROVE, LLC'S OPENING BRIEF ON THE MERITS

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ISSUE PRESENTED

1. What analytical framework should apply in determining the enforceability of co-tenancy provisions in retail lease agreements?

   Answer: Whether the provision bears a reasonable relationship to the range of actual damages the parties could have anticipated would flow from the failure of the co-tenant to open.

2. Did the Court of Appeal correctly determine that the co-tenancy provision in this case is enforceable?

   Answer: No. Analyzed under Civil Code § 3275, the penalty imposed on JJD-HOV bears no reasonable relationship to the harm the parties could have anticipated from the failure of the co-tenant to open, especially given the absence of any loss whatsoever to Jo-Ann. Analyzed under Civil Code § 1671, the provision remains an unreasonable penalty given the lack of anticipated or actual damage to Jo-Ann, particularly so when the application of the exact same penalty ("Substitute Rent") applies to wildly different circumstances, rebutting any presumption it represents a reasonable effort to approximate the harm caused.

INTRODUCTION

The law, like equity, abhors a forfeiture. (Civ. Code § 1442; *Hopkins v. Woodward* (1932) 216 Cal. 619, 622.) The facts establish that Appellant JJD-HOV Elk Grove (the landlord) will

suffer a forfeiture if the co-tenancy provision in its lease with Respondent Jo-Ann Stores (the tenant) is enforced. The question is whether JJD should suffer this forfeiture because the parties' retail lease agreement was negotiated by commercially sophisticated parties, as the Third District has held. Twenty-five years ago, in *Ridgley v. Topa Thrift & Loan Ass'n* (1998) 17 Cal.4th 970 (*Ridgley*), this Court in finding a functional late fee on a loan to be an unenforceable penalty, answered that question in the negative, making clear the State's codified protection against contractual forfeitures applies to all manner of contracting party:

> The dissent suggests a different set of rules must apply because this was an "arm's-length commercial transaction." (Dis. opn., post, at p. 983.) That plaintiffs are small business owners rather than consumers, however, does not deprive them of section 1671's protection against unreasonable penalties **<u>or of the right to relief from contractual forfeiture under section 3275</u>**. Similarly, we reject Topa's oral argument suggestion that our *Garrett* decision does not apply because it predates the 1977 repeal of former section 1670 and the simultaneous amendment of section 1671. Nothing in the 1977 legislation indicates an intent to abrogate *Garrett*'s analysis of unjustified late fees as unenforceable penalties, an analysis that has been cited and followed in several post-1977 decisions (*see, e.g., Perdue v. Crocker National Bank*, supra, 38 Cal.3d at p. 931; *Baypoint Mortgage Corp. v. Crest Premium Real Estate etc. Trust*, supra, 168 Cal.App.3d at pp. 829-830) and **<u>which reflects as well the longstanding and still operative principle of allowing relief from contractual forfeitures.</u>**

(*Ridgley*, *supra*, 17 Cal. 4th at 981 fn.5 (emphasis added).)

This Court's precedent establishes a simple, equitable, and fair bright line rule, consistent with the legislative and judicial history of this State, that should not be disturbed: no contractual provision will be enforced if it operates as a penalty.

California's Civil Code, like many jurisdictions throughout the world, contains an express prohibition against contractual penalties. (Civ. Code § 3275.) This legislatively enacted provision, unchanged since the Code's passage in 1872, helps ensure that contracts under California law serve a rational economic purpose rather than function like a lotto where a dollar in default gives a million in reward. As repeatedly explained by this Court:

> "A penalty provision operates to compel performance of an act [citation] and usually becomes effective only in the event of default [citation] upon which a forfeiture is compelled without regard to the damages sustained by the party aggrieved by the breach [citation]. The characteristic feature of a penalty is its lack of proportional relation to the damages which may actually flow from failure to perform under a contract. [Citations.]"

(*Ridgley*, *supra*, 17 Cal.4th at 977 [quoting *Garrett v. Coast & Southern Fed. Sav. & Loan Assn.* (1973) 9 Cal.3d 731, 739].)

In *Grand Prospect Partners, L.P. v. Ross Dress for Less, Inc.* (2015) 232 Cal.App.4th 1332 (*Grand Prospect*), the Fifth District Court of Appeal applied this general framework to the specific case of co-tenancy provisions in retail lease agreements, which impose a loss (through reduced rent) on landlords if there fails to be a certain occupancy rate in a shopping center. The Court of Appeal below rejected that approach, holding, "we may not

rewrite what [the parties] themselves wrote," and that the payment of Substitute Rent was a provision for "dual or alternative rent provisions rather than an unenforceable penalty." (Op. at pp. 14-15, 17 [quoting *Aerojet-General Corp. v. Transport Indemnity Co.* (1997) 17 Cal.4th 38, 75].) The Court of Appeal, by apparently defining at least this co-tenancy agreement—though it is the standard type—as a form of alternative performance, ruled it must be enforced as written, effectively immunizing standard co-tenancy provisions in retail lease agreements from penalty analysis under Section 3275. That was error.

While this Court does recognize that a party who has effectively elected an "alternative performance" cannot claim that performance is a penalty, the Court of Appeal below misapplied this Court's alternative performance analysis. Alternative performance applies when the party subject to the forfeiture undertakes a voluntary act and enforcement of the provision is necessary to preserve the integrity of the agreement. For example:

> In contrast to late payment fees, contractual charges for *prepayment* of the loan principal are generally considered valid provisions for alternative performance, rather than penalties or liquidated damages for breach. Payment before maturity is not a breach of the contract, but simply an additional mode of performance on the borrower's part; the prepayment charge is not a penalty imposed for default, but an agreed form of compensation to the lender for interest lost through prepayment, additional tax liability or other disadvantage.

(*Id.* at 978 [emphasis in original].)

As between these modes of analysis—penalty versus alternative performance—there cannot be any serious doubt about which should apply to co-tenancy provisions in retail lease agreements. The failure of a landlord to satisfy a co-tenancy provision is nothing like prepayment of a loan – a voluntary choice by the party subject to the "penalty" and a provision which exists to ensure the other party to the contract – the lender – receives their benefit of the bargain; why would a lender make a loan and incur significant transaction costs if it could be repaid the very next day with no accounting for the interest the lender expected?

It is for this reason that the trial court and Court of Appeal's inordinate reliance on *Constellation-F, LLC v. World Trading 23, Inc.* (2020) 45 Cal.App.5th 22 (*Constellation-F*) – a case involving holdover rent – was misplaced. *Constellation-F* concerned a tenant's uncoerced decision to stay in the leased premises beyond the term and pay an increased rent amount. The *Constellation-F* court refused to relieve the tenant of the volitional choice it made, functionally finding it a valid form of alternative performance. Both *Constellation-F* and *Ridgely* stand for the unremarkable proposition that contract provisions that may appear to be penalties are nonetheless enforceable as forms of alternative performance if the party claiming they are being penalized made a free choice with a specified contractual consequence. Whether it be a tenant deciding to remain in the premises after their lease's expiration and paying increased rent (*Constellation-F*), or a borrower choosing to escape a high interest

rate loan to pay it off earlier (*Ridgley*), neither circumstance is similar to the failure of a co-tenant to open, something that is not a "choice" of JJD's.[1] The failure of a contractual condition (occupancy drops below 60%) is also unalike an affirmative act which exists in the case of alternative performance (like prepaying a loan or staying in the premises).

Given that co-tenancy provisions cannot reasonably be classified as forms of alternative performance, the relevant standard must then be either the neutral penalty analysis of *Grand Prospect* or the rebuttable presumption of enforceability applicable to commercial agreements under Civil Code Section 1671. Either standard invalidates the co-tenancy provision at issue in this litigation.

The rule of *Grand Prospect*, modeled after this Court's decision in *Ridgley*, is that the enforceability of a co-tenancy provision requires "the comparison of (1) the value of the money or property forfeited or transferred to the party protected by the condition to (2) the range of harm or damages anticipated to be caused that party by the failure of the condition." (*Grand Prospect*, *supra*, 232 Cal.App.4th at 1358.) "If the forfeiture or transfer bears no reasonable relationship to the range of anticipated harm, the condition will be deemed an unenforceable

---

1 If interpreted loosely enough, every penalty case involves a "choice." Want to avoid a late fee equal to two percent of an outstanding loan? (*Garrett v. Coast & Southern Fed. Sav. & Loan Assn.* (1973) 9 Cal.3d 731.) "Choose" to make the payment on time. Accepting the Court of Appeal's reasoning dangerously blurs the line between enforceable contract conditions and penalties such that any penalty could be enforced as a choice.

penalty." (*Ibid.*) Similarly, Civil Code section 1671 provides "a provision in a contract liquidating damages for the breach of the contract" may be found to be an unenforceable penalty if "the party seeking to invalidate [it] establishes [it] was unreasonable under the circumstances existing at the time the contract was made." (Civ. Code, § 1671, subd. (b).) Thus, under either *Grand Prospect* or Section 1671, a contract provision will not be enforced if it is a penalty, and a provision is a penalty if it is unreasonable; *i.e.*, there is no reasonable relationship between the breach and contractual result.

In bypassing the *Grand Prospect* analysis (and refusing to engage in a Section 1671 analysis), both the trial court and Court of Appeal placed great emphasis on the fact that this provision was negotiated—and effectively all retail lease agreements are negotiated. That negotiation, however, does not immunize the contract from a penalty analysis, and there is no legal authority holding otherwise. This is especially so when Jo-Ann offered no evidence that the parties attempted to approximate what damage might flow from JJD's temporary inability to fulfill the co-tenancy provision or that vacancy would impact its profitability. This fact is demonstrated by the lease itself, with the chosen measure of damage, the much-reduced "Substitute Rent" term, applying to a host of potentially different circumstances, such as the opening of a church, an adult book store, a gun range, a school, a gym, or an explosives warehouse in the mall, or the failure of a co-tenant to open. While there is no conceivable equivalence among these occurrences—the consequence to Jo-

Ann's remains the same: a windfall of over $30,000 per month because it need only pay "Substitute Rent."

In choosing to value the generic notion that negotiated contracts should be enforced as written over one of the California Legislature's time-tested regulations of negotiated contracts, the Court of Appeal below has imperiled all contractual regulation. Agreements to gamble can be negotiated, as can agreements to usurious loan rates. Agreements to engage in discrimination, like agreements to waive un-waivable protections, are just as easily a product of negotiation. But calling a penalty for renting to a minority business owner "alternative performance" cannot—and should not—save it. "To so hold would be to condone a result which, although directly prohibited by the Legislature, may nevertheless be indirectly accomplished through the imagination of inventive minds." (*Garrett*, *supra*, 9 Cal. 3d at 737.)

This is particularly so where the California Legislature has demonstrated that it knows perfectly well how to exempt certain classes of contract from penalty analysis (*e.g.*, Welf. & Inst. Code § 14018.5), has not done so for retail lease agreements, and has acquiesced in the judicial decisions interpreting Section 3275. If Jo-Ann desires to contract for windfalls outstripping any reasonable relation to its potential damages, it may petition the Legislature to craft an exception. In the meantime, it should pay its rent or, in some future case, elect to offer evidence of actual damages (which Section 3275 still allows it to recover), or prove that any default by JJD was a "grossly negligent, willful, or

fraudulent breach of duty" (in which case Section 3275's terms would allow recovery of even the penalty).

JJD respectfully submits that the judgment below should be reversed and rendered in its favor.

FACTS & PROCEEDINGS

As the Court of Appeal noted, "the facts are largely undisputed." (Op. at p. 2.) JJD-HOV Elk Grove, LLC ("JJD") is a family-owned commercial landlord that operates a shopping center in Elk Grove, California. (*Id.* at p. 3; AA 447.2) For all relevant purposes, JJD leased approximately 35,000 square feet of space to Jo-Ann Stores, LLC ("Jo-Ann"), a national retailer of fabric, sewing supplies, and related items, in 2003. (*Id.* at p. 3; AA 426.) The parties' lease contains a co-tenancy provision.

"Cotenancy requirements are generally found only in retail leases," and "condition[] a retail tenant's opening for business, or continuing operation of its business at the designated premises, on the opening for business or continued operation by other tenants in the shopping center." (Op. at pp. 6-7 [quoting *Retail Leasing: Drafting and Negotiating the Lease* (Cont. Ed. Bar 2021 supp.) Cotenancy Requirements, § 7.1].) Co-tenancy provisions allow tenants to reduce their rent if a certain number of tenants at the retail space leave or are unopen for business.[3]

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[2] References to the Court of Appeal opinion appear as "Op. at p. __." References to the record in the Court of Appeal are given by "AA __," which refers to the Appellant's Appendix.

3 Prior cases have tended to refer to co-tenancy provisions as "conditions" rather than "covenants," although they partake of the character of both: a covenant because they are a promise to

The co-tenancy provision in the lease between JJD and Jo-Ann provides: "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)." (Op. at p. 3 [added emphasis removed].) When the co-tenancy provision is not satisfied, the contract provides that Jo-Ann may pay "Substitute Rent" in lieu of the otherwise-applicable "Fixed Minimum Rent." (*Ibid.*) "Fixed Minimum Rent" at the time the complaint was filed was, and currently is, "$42,292 per month." (*Ibid.*) "Substitute Rent" is defined as "the greater of 3.5 percent of Jo-Ann's gross sales (except pattern sales), or $12,000 per month." (*Ibid.*) Jo-Ann has never, across the nearly twenty years of operation at this location, had gross sales sufficient to trigger the percentage-based definition.

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maintain a certain occupancy rate; a condition because they change the scope of a party's performance depending whether or not they are satisfied. (Miller & Starr, *Covenants and conditions distinguished* (4th ed., West 2022) 10 Cal. Real Est. § 34:51.) The law favors construction of dual-role provisions as covenants so as to avoid forfeiture. (*Ibid.*) JJD does not press this distinction because, under *Grand Prospect*, it does not matter. (*Grand Prospect, supra,* 232 Cal.App.4th at 1358 ["In other words, an unenforceable penalty bears no reasonable relationship to the range of actual damages the parties could have anticipated would flow from a breach of a covenant or a failure of a condition." (internal quotation marks omitted)].) To the extent the Court departs from *Grand Prospect* analysis, however, JJD maintains co-tenancy provisions should be construed as covenants.

Failure of the co-tenancy provision is not the only circumstance under which the lease refers to "Substitute Rent." The lease purports to permit Jo-Ann to pay "Substitute Rent" if any of the following were to open:

> A movie theater (except as shown on the Site Plan); auditorium; meeting hall; church; bingo hall or place of public assembly; library; sale or service of automobiles or other vehicles; bar serving alcoholic beverages except as incidental to a restaurant; funeral parlor; massage parlor; animal clinic; discotheque; dance hall (or otherwise for musical/dance reviews or topless/nude shows); karate, gymnasium; skating rink; off-track betting establishment; game room within Two Hundred (200) feet of the exterior of the Premises; amusement arcade, gallery or store within Two Hundred (200) feet of the exterior of the Premises; pinball arcade within Two Hundred (200) feet of the exterior of the Premises; so-called "flea market"; second hand or used goods store or store selling primarily distressed or damaged merchandise; pool room; bowling alley; health club or spa within Two Hundred (200) feet of the exterior of the Premises; so-called "head shop"; night club; school; gun range or gun shop; or any business use which emits offensive odors, fumes, dust or vapors; is a public or private nuisance; emits loud noise or sounds which are objectionable; creates fire, explosive or other hazard; warehousing, except as incidental to a retail business; adult book store or store selling or exhibiting sexually explicit materials . . . .

(AA 260.)

The amount of Substitute Rent was negotiated by the parties, with the initial draft lease setting it at $2,000 a month. It was subsequently negotiated to the operable provision, *i.e.*, 3.5% or $12,000 a month. (AA 466.) There is no evidence

indicating why Substitute Rent was increased by 600% from the proposed term as compared to the final agreement; both the proposed term, and what was ultimately agreed to, appear to have been selected at random. (*Ibid.*)

At the trial court level, after having engaged in substantial discovery and with the assistance of counsel, Jo-Ann offered the following evidence to support its claim that the co-tenancy provision represents a reasonable effort to approximate damage:

> **Statement**: Neither the Lease nor any documentation from the initial negotiations contain any information as to the ***basis*** for the penalty other than that the co-tenancy provision was an "inducement" to get Jo-Ann to sign the Lease.
>
> **Opposition**: Disputed, as Sections 15 and 2(u) of the Lease does not constitute a "penalty" (nor were ever referred to in the Lease as a "penalty"), and, further, as part of the negotiation of the terms of the original Lease Agreement in 2003, the parties discussed, negotiated and agreed upon the terms of the "Co-Tenancy" provision contained in Section 15. Specifically, in response to Landlord's original "Letter of Intent" dated October 8, 2002, Jo-Ann's "Lease Information Sheet" dated December 4, 2002 noted "Substitute rent of $2,000 or 3% of sales" and provided Landlord with a "1st draft lease" on December 10, 2002. Thereafter, on February 25, 2003, the parties (with counsel) discussed "what is substitute rent?" and reflected in handwritten notes that the "substitute rent" had been negotiated up, i.e., increased from "(i) 3 % of sales . . . (ii) $2000/mo." to "3.5% . . . $12,000.00".

(AA 466, Separate Statement No. 35.) Or, put more simply, Jo-Ann's evidence of reasonableness is a recitation of facts proving the undisputed point that the parties negotiated this term.

Rent payments on the lease commenced September 17, 2004, and six days later, on September 23, 2004, Jo-Ann invoked the co-tenancy provision for the first time to pay Substitute Rent. (AA 951.)

There is no dispute that, during the relevant time period, the co-tenancy provision was unsatisfied. There is a dispute as to whether it was within JJD's power to satisfy the condition. Occupancy dropped below the co-tenancy provision's threshold because, in 2017, an anchor tenant (Toy "R" Us) sought bankruptcy protection, and the bankruptcy court assumed control over the lease and premises. (AA 458-459.)

The Toys "R" Us space, taken out of JJD's control by the bankruptcy court is 50,000 square feet out of a total mall space of 145,000 square feet. (AA 90, 277.) Under section 15(a), to avoid the tenancy penalty, JJD had to lease at least sixty percent (60%) of the total mall space. But once the 50,000 square feet is removed, only 95,000 square feet remained. 60% of 145,000 square feet is 87,000. So to avoid the penalty, the shopping center had to have operating tenants for 87,000 square feet out of an available 95,000 square feet, approximately 92% of the commercially available space.

After the bankruptcy court permitted the sale of the lease, there is no dispute that the co-tenancy provision was again satisfied. (Op. at p. 5.) During the period the bankruptcy court precluded JJD from replacing the anchor tenant, Jo-Ann maintained it had the right to pay Substitute Rent of $12,000 instead of the Fixed Minimum Rent of $42,292. (Op. at p. 3.) If

the co-tenancy provision is enforceable, Jo-Ann is correct. If the provision is not enforceable, Jo-Ann owes JJD substantial back rent.

The present case arises out of JJD's action for declaratory relief and breach of contract, which asserts that the parties' particular co-tenancy provision constitutes an unenforceable penalty. (Op. at p. 5.) JJD maintains that, inasmuch as Jo-Ann declined to produce evidence of *any* financial loss from the temporary failure of the co-tenancy provision (and admitted that "Substitute Rent" was never intended to reflect actual damages), a 72% reduction in rent works a forfeiture under *Grand Prospect* and the cases applying California Civil Code § 3275. (JJD Opening Brief at p. 8.) That is, the value of the property the co-tenancy provision forces JJD to forfeit (more than $30,000 per month) bears no reasonable relationship to any harm to Jo-Ann ($0 per month), nor could any reasonable person have assumed that the opening of a church, an adult bookstore, an explosion hazard, or a gym within 199 feet of Jo-Ann (but not 201 feet from Jo-Ann) and failure of the co-tenancy provision would all produce equivalent harm to Jo-Ann. (*Id.* at p. 21.)

The trial court declined to conduct a *Grand Prospect* analysis and instead relied on the non-unanimous decision in *Constellation-F, LLC v. World Trading 23, Inc.* (2020) 45 Cal.App.5th 22, a Second District case concerning holdover-rent provisions.[4] (AA 1032.) Foreshadowing the Court of Appeal's

4 Of perhaps some note, the parties' lease contains a holdover rent provision (AA 268), but it is nowhere at issue in this case.

reasoning, the trial court held that the co-tenancy provision is enforceable because it was the result of negotiation between sophisticated parties. (*Ibid.*)

JJD timely appealed, asserting without dispute that while *Grand Prospect* considered and rejected the landlord's *unconscionability* argument because of the sophisticated negotiation between the parties, the court did not consider such negotiations dispositive of the landlord's *penalty* claim under Section 3275. (Op. at pp. 8-10.) In a published opinion, the Court of Appeal expressly rejected the *Grand Prospect* framework and held: "[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." (Op. at p. 14.) The Court of Appeal did purport to hold open the possibility that a co-tenancy provision if phrased in terms of liquidated damages might run afoul of California Civil Code § 1671. (Op. at p. 13 & n.6.) But it concluded that this co-tenancy agreement was simply a form of alternative performance and therefore wholly immune to penalty analysis, whether under Section 3275 or Section 1671. (Op. at p. 17.)

JJD filed a timely petition for review, which this Court granted on October 12, 2022. The Court has identified the issues as: "(1) What analytical framework should be applied in determining the enforceability of co-tenancy provisions in retail lease agreements? (2) Did the Court of Appeal correctly determine that the co-tenancy provision in this case is enforceable?"

ARGUMENT

Fundamentally, the enforceability of this co-tenancy clause depends on whether California law exalts *laissez faire* freedom of contract above all else, as the lower courts' decisions would, or if California's tried-and-true approach to regulated capitalism, reflected in a suite of statutorily enacted protections and privileges, better serves the policies of this State. (*See Ridgley, supra*, 17 Cal.4th at 981 fn.5.)

I. The Court of Appeal's Approach Is Flawed and Inconsistent with this Court's Teachings.

A. It Is Hornbook California Law That Negotiated Contracts Between Sophisticated Parties Are Not, Ipso Facto, Enforceable.

Coursing throughout the Court of Appeal's opinion, like through that of the otherwise-distinguishable opinion cited by the trial court (*Constellation-F, LLC v. World Trading 23, Inc.* (2020) 45 Cal.App.5th 22), is a sense of disbelief that a court might decline to enforce a negotiated provision of a commercial agreement. In fact, positive law, protecting a wide spectrum of interests, precludes the enforcement of many negotiated provisions, both in California and the rest of the world. Specifically, in jurisdictions influenced by the civil code tradition—but even in law of England—attempts to use penalties to compel contractual performance are widely regulated because they are inimical to the orderly conduct of business.

Unlike some other states, such as Nevada, Tennessee, and Oregon, each cited by the Court of Appeal, California believes in and has found great success in regulated capitalism rather than

an anything-goes approach. (Op. at p. 8 n.3.) The Court of Appeal's willingness to disregard a provision of the Civil Code, applied by this Court to a commercial agreement in the not-too-distant past, with no textual basis or jurisprudential support, means that a number of other business regulations are at risk.

Thus one now wonders—and commercial parties, which have the resources and often the dollar incentives to try out questionable legal theories in the hope of big returns, will certainly question—whether California's numerous other legislative and judicial policies are subject to attack. For example, is our "elaborate and interrelated set of foreclosure and anti-deficiency statutes relating to the enforcement of obligations secured by interests in real property" next to fall? (*Alliance Mortgage Co. v. Rothwell* (1995) 10 Cal.4th 1226, 1236.) They "were enacted as the result of 'the Great Depression and the corresponding legislative abhorrence of the all too common foreclosures and forfeitures [which occurred] during that era for reasons beyond the control of the debtors.'" (*Ibid.*) The same kind of statute, the same kinds of parties. What will become of these rules?

So too can the question be asked of California's "strong public policy against agreements containing covenants not to compete," which are by definition commercial and often extensively negotiated in other states. (Agreements Not To Compete, *Overview*, Cal. Civ. Prac. Business Litigation § 62:1.) Usurious loans, contracts resulting in unfair competition, discriminatory contracts—all of the laws governing such matters

run afoul of unfettered freedom of contract. (*See generally id.* at §§ 58:8, 60:6, 63:17-18; *Hardwick v. Wilcox* (2017) 11 Cal.App.5th 975, 977.) Under the Court of Appeal's reasoning, can commercial parties contract to a discriminatory restrictive covenant in real estate? (*E.g., Broadmoor San Clemente Homeowners Assn. v. Nelson* (1994) 25 Cal.App.4th 1, 4.) What about including an illegal object or term in a real estate agreement? (*E.g.*, *MKB Mgmt., Inc. v. Melikian* (2010) 184 Cal.App.4th 796, 798.) A gambling wager between sophisticated parties is also unenforceable in this state. (*Kyne v. Kyne* (1940) 16 Cal.2d 436, 438.) As are contracts which have for their object, directly or indirectly, to exempt anyone from responsibility for their own fraud or willful injury to person or property. (Civ. Code § 1668.) May parties now try (again) to contract around the disgorgement provisions of the Contractors' State License Law. (*Ahdout v. Hekmatjah* (2013) 213 Cal.App.4th 21, 37-40.)

The list goes on. Even if some or all of these other areas survive renewed judicial scrutiny, there will be a period of instability while well-heeled commercial parties test the waters.

Now is not the time for the California courts to take California business law backwards. California law, like the law of all states to a greater or lesser extent, withdraws from private parties the right to make certain choices—whether they be commercial parties or not. It does so in service of the public interest, as determined by the Legislature. Upending fundamental, long-established principles of law duly enacted by the people's representatives based on judicial will rather than

text or history, and all in the name of freedom of contract, does not serve the parties, the courts, the public interest, or the role of contracts in modern economies.

Retail lease agreements, it bears mentioning, are a very poor candidate for allowing egregious forfeitures such as that involved in the present case. The physical retail leasing industry (colloquially, mall owners) is under enormous stress from online retailers, a stress made all the more acute by pandemics that make concentrations of people unwise. While each industry must change with the times and bear the risks of the future, an orderly transition rather than a wholesale collapse of the industry depends on incremental, fair progress. Giving national chain stores huge windfalls at the expense of local commercial landlords will have serious, unfortunate consequences for the California real estate market.

B. Co-tenancy Provisions In Retail Lease Agreements Are Not A Species Of "Alternative Performance" But Potential Penalties

In holding the co-tenancy provision enforceable, the Court of Appeal below, citing to *Constellation-F, LLC v. World Trading 23, Inc.* (2020) 45 Cal.App.5th 22, wrote "a contractual provision that provides for alternative performance or different rents is valid" and that this co-tenancy clause constituted "a valid and enforceable 'dual' or 'alternative' rent provision rather than an unenforceable penalty." (Op. at p. 17.) The Court's analysis is wrong.

This Court last addressed the operation of Section 3275 at length in *Ridgley v. Topa Thrift & Loan Ass'n* (1998) 17 Cal.4th

970 and that opinion helps illustrate the difference between alternative performance and a penalty.

As part of Robert Ridgley's business, he bought a parcel of land to develop into condos for speculation and sale. (*Id.* at 973.) After construction was almost complete, Ridgley sought a bridge loan from Topa Thrift & Loan to cover the gap between the construction loan and conclusion of a buyer's permanent loan. (*Ibid.*) A dispute arose because Topa assessed a prepayment penalty against Ridgley based on a prior late payment on the loan, and the question arose whether the clause cited by Topa was a prepayment fee, which is a species of alternative performance generally immune from Section 3275 scrutiny, or a penalty for prior late payment, to which Section 3275 does apply. (*Id.* at 976.)

The Court addressed this nuanced issue, which partook of both a prepayment penalty (because it was being assessed for early payment of the loan) and a penalty for default or breach (because it was only being assessed based on Ridgley's failure to maintain a perfect record of on-time payments), in terms instructive here:

> "A penalty provision operates to compel performance of an act [citation] and usually becomes effective only in the event of default [citation] upon which a forfeiture is compelled without regard to the damages sustained by the party aggrieved by the breach [citation]. The characteristic feature of a penalty is its lack of proportional relation to the damages which may actually flow from failure to perform under a contract. [Citations.]"

> In short, "[a]n amount disproportionate to the anticipated damages is termed a 'penalty.' A contractual provision imposing a 'penalty' is ineffective, and the wronged party can collect only the actual damages sustained."
>
> . . .
>
> Pursuant to these principles, charges for late payment of loan installments have been held unenforceable where they bore no reasonable relationship to the injury the creditor might suffer from such late payments.

(*Id.* at 977 [quoting *Garrett v. Coast & Southern Fed. Sav. & Loan Assn.* (1973) 9 Cal.3d 731, 739; *Perdue v. Crocker National Bank* (1985) 38 Cal.3d 913, 931].)

"In contrast to late payment fees," however, "contractual charges for *prepayment* of the loan principal are generally considered valid provisions for alternative performance, rather than penalties or liquidated damages for breach." (*Id.* at 978 [emphasis in original].) "Payment before maturity is not a breach of the contract, but simply an additional mode of performance on the borrower's part; the prepayment charge is not a penalty imposed for default, but an agreed form of compensation to the lender for interest lost through prepayment, additional tax liability or other disadvantage." (*Ibid.*) Thus, "[a]lthough the word 'penalty' is used, and perhaps properly so in that a charge is made which is equivalent to unearned interest, there is no penalty in the sense of retribution for breach of an agreement, nor is there provision for liquidated damages because of ascertaining what the damages for such breach may be." (*Id.* at 979.) "Nor is the case one in which there is forfeiture for a

default which, under appropriate circumstances, may be relieved under Civil Code section 3275." (*Ibid.* [citations omitted].) "Indeed, in the case before us there is the opposite of default, that is, a payment made before the promissor was obligated to make it." (*Ibid.*)

In *Constellation-F, LLC v. World Trading 23, Inc.* (2020) 45 Cal.App.5th 22, the Second District held that a holdover rent provision[5] triggering a rental increase of 150% did not constitute an unenforceable penalty. The court's opinion was rooted in a collection of cases specifically finding that hold-over rent provisions do not constitute penalties and was motivated, in part, by the simple fact that "[the tenant was not] subject to coercion after the [rental increase]. [The tenant] was at complete liberty to avoid the higher rent. It had to merely leave." (*Id.* at 29.) *Constellation-F* can fairly be read as enforcing the holdover rent provision because the lease agreement provided for alternative performance: the tenant could stay in the premises and pay a sum certain or vacate to avoid the increased rent.

Ridgley and *Constellation-F* define the contours of an alternative performance analysis. It applies when the party subject to penalty voluntarily, and therefore presumably in their economic interest, decides to perform a certain act with a specified contractual consequence. The alleged penalty does not

5 Holdover rent provisions provide that the tenant shall pay an increased rent if it remains in the building past the date of the lease's expiration (*e.g.*, on month sixty one of a five-year lease, the rent goes up fifty percent if the tenant does not vacate the premises).

arise from the failure of a contract condition or covenant; it is a feature of the contract which occurs when the contracting party undertakes a discretionary act. Contrast that with a co-tenancy provision where: (i) the party subject to the forfeiture (JJD) is not undertaking a voluntary act (JJD did not decide for Toys-R-Us to declare bankruptcy and cannot unilaterally decide whether a replacement tenant signs a lease in its shopping center); and (ii) the co-tenancy provision was not triggered because of a positive act (voluntarily pay a loan early or stay in the premises beyond the lease term) with a specified outcome – a prepayment penalty or increased rent. It was triggered by the failure of a specific covenant in the contract; occupancy fell below an arbitrary rate and thus "Substitute Rent" applied. Whether it be deciding to pay a loan early (*Ridgley*), or remaining in a property beyond the lease term (*Constellation-F*), in neither instance is there the **failure** of a contractual condition or covenant.

Ridgley and *Constellation-F* are also consistent with the efficient functioning of markets. *Ridgley*'s approval of a prepayment penalty is, in part, a recognition that a lender's acceptable rate of return, embedded transactional costs, risk tolerance depends upon the length of the loan. A lender may be willing to incur costs to originate a loan where it receives a twelve percent annual return on a ten year note, but perhaps not if that same loan can be repaid in two weeks. And if a borrower is willing to prepay a loan knowing there is fixed cost associated with it to ensure the lender receives its benefit of the bargain, then a finding of alternative performance comports with freedom

of contract and efficient market operations. Indeed, the *Ridgley* opinion acknowledged this market reality, approvingly citing to the dissent from the Court of Appeal below it, which noted a valid prepayment penalty for a loan can function to account for the "administrative costs of negotiating this loan and then replacing it with a new loan… ." (*Ridgley v. Topa Thrift & Loan Ass'n*, *supra*, 17 Cal.4th 980.)

The same can also be said of *Constellation-F,* its holding being a recognition of the fact that rental rates at the end of a long-term commercial lease are unknowable at the time of contracting and could be significantly greater than what the parties agreed to. Holdover rent provisions provide economic protection to the landlord. If a tenant desires to stay and pay a higher rate, then the efficient market and freedom of contract are again vindicated because the tenant is making a voluntary choice that presumably benefits both parties. The Court of Appeal in *Constellation-F* rejected the penalty argument because the party invoking it made a voluntary choice with a fixed consequence: "[The tenant] was at complete liberty to avoid the higher rent. It had merely to leave." (*Constellation-F*, *supra*, 45 Cal.App.5th at 29.)

Applying the co-tenancy penalty in this case, as compared to *Ridgley* and *Constellation-F*, furthers no economic interest and JJD is not "choosing" to have reduced occupancy any more than a party subject to a fifty percent fee if they are on day late in

making a payment on a loan is "choosing" for that to occur[6]. Enforcing this co-tenancy penalty yields no market efficiencies because there is no rational actor electing an alternative course of performance while appreciating the consequence of that choice. This is Jo-Ann admitting it has suffered no harm yet seeking to enforce the co-tenancy penalty because it believes it can, to the detriment of JJD.

II. ***Grand Prospect*'s Section 3275 Approach Is the Correct Analysis for the Enforceability of Co-Tenancy Provisions in Retail Leases.**

The courts of this State have repeatedly confirmed that the protection against forfeitures under Section 3275 applies to commercially sophisticated parties, even after a 1970s-era amendment weakened California's regulation of commercial liquidated damages clauses (which while not directly applicable here also finds its roots in Section 3275's rule against contractual penalties). The carefully constructed and meticulously supported framework of *Grand Prospect Partners, L.P. v. Ross Dress for Less, Inc.* (2015) 232 Cal.App.4th 1332, while the first to apply Section 3275 analysis to co-tenancy agreements in retail leases, follows in the long line of cases teaching the same rule: "An unenforceable penalty 'bears no reasonable relationship to the

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6 This Court's decision in *Garrett* invalidated a late payment fee on a loan equal to two percent (2%) of the outstanding principal balance. Just like the borrowers in *Garrett* were afforded protections against penalties without considering whether they *could* have made the monthly payment (i.e. take out another loan, sell assets, etc.), JJD cannot be faulted for "failing" to lease the premises. If it could have, it would have, as no landlord voluntary foregoes rent.

range of actual damages the parties could have anticipated would flow' from a breach of a covenant or a failure of a condition." (*Grand Prospect*, *supra*, 232 Cal.App.4th at 1358 [quoting *Greentree Financial Group, Inc. v. Execute Sports, Inc.* (2008) 163 Cal.App.4th 495, 497]; *see also Ridgley v. Topa Thrift & Loan Assn.* (1998) 17 Cal.4th 970, 977.)

In *Grand Prospect*, the Fifth District Court of Appeal was tasked with deciding whether a co-tenancy provision between a commercial landlord and commercial tenant constituted a forfeiture. The tenant received monthly rent abatement from $39,500 to $0 due to a co-tenant's failure to open, despite the tenant not identifying any damage caused from a violation of the provision.

The Fifth District's detailed opinion reviewed the fundamental principles governing forfeitures and surveyed California law stretching back over one-hundred years. The court analyzed each argument set forth by the parties and first disposed of the landlord's argument that the co-tenancy provision was unconscionable. (*Grand Prospect*, *supra*, 232 Cal.App.4th at 1354.) Unconscionability, the court noted, requires some form of procedural abuse; an unequal bargaining position, undue pressure, or a lack of meaningful choice. (*Id*. at 1348-1349.) The parties in *Grand Prospect*, however, were sophisticated and the lease terms were "heavily negotiated." (*Id*. at 1350.) Thus, the lease provision was not unconscionable. (*Ibid*.)

The Court then turned to whether the clause constituted a forfeiture. The Court began by recognizing "the law has long

strictly scrutinized—and often prohibited through the use of a principle inherently incapable of precise articulation or application—the enforcement of forfeitures or penalties . . . ." (*Id.* at 1355 [quoting 14 Williston on Contracts (4th ed. 2013) § 42:1, pp. 404-407].) In an apparent rejection of the drafting cleverness of a term, the court noted substance is to govern over form—California law, "does not allow unreasonable penalties or forfeitures simply because they are imaginatively drafted as contractual conditions." (*Id.* at 1356.) The reviewing court directed trial courts to "determine a contract provision's true **function** and operation when evaluating its legality." (*Ibid.* [emphasis added].) The test to determine if a provision constitutes an enforceable penalty requires, "the comparison of (1) the value of the money or property forfeited or transferred to the party protected by the condition to (2) the range of harm or damages anticipated to be caused that party by the failure of the condition." (*Id.* at 1358.) "If the forfeiture or transfer bears no reasonable relationship to the range of anticipated harm, the condition will be deemed an unenforceable penalty." (*Ibid.*)

The rule of *Grand Prospect* – no contractual provision regardless of circumstance will be enforced if it operates as a penalty – was, prior to the Court of Appeal's opinion, the only decision on point, worked for nearly eight years and enjoyed the acquiescence of the Legislature. Its holding, consistent with Section 3275, promotes the purpose of the law of contracts, which is to serve rational business interests rather than to punish putative wrongdoing. (*Freeman & Mills, Inc. v. Belcher Oil Co.*

(1995) 11 Cal. 4th 85, 94 ["[T]he purpose of contract damages to compensate the injured party rather than punish the breaching party."].)

A. This Court Has Repeatedly Applied Section 3275 To Void Contractual Penalty Provisions, Including In Negotiated Commercial Agreements.

The fact of a contract's status as commercial or non-commercial, negotiated or not negotiated either went undiscussed or was considered irrelevant in this Court's early decisions under Section 3275. (*Garrett v. Coast & S. Fed. Sav. & Loan Assn.* (1973) 9 Cal. 3d 731; *Baffa v. Johnson* (1950) 35 Cal. 2d 36.)

Perhaps more to the point, this Court's most recent application of Section 3275, post-dating by more than twenty years the amendment to Section 1671 which does recognize a commercial versus non-commercial distinction, affirmatively rejected the argument that the commercial nature of an agreement is relevant under its Section 3275 analysis:

> The dissent suggests a different set of rules must apply because this was an "arm's-length commercial transaction." (Dis. opn., post, at p. 983.) That plaintiffs are small business owners rather than consumers, however, does not deprive them of section 1671's protection against unreasonable penalties or of the right to relief from contractual forfeiture under section 3275. Similarly, we reject Topa's oral argument suggestion that our *Garrett* decision does not apply because it predates the 1977 repeal of former section 1670 and the simultaneous amendment of section 1671. Nothing in the 1977 legislation indicates an intent to abrogate *Garrett*'s analysis of unjustified late fees as unenforceable penalties, an analysis that has been cited and

> followed in several post-1977 decisions (*see, e.g., Perdue v. Crocker National Bank*, supra, 38 Cal.3d at p. 931; *Baypoint Mortgage Corp. v. Crest Premium Real Estate etc. Trust*, supra, 168 Cal.App.3d at pp. 829-830) and which reflects as well the longstanding and still operative principle of allowing relief from contractual forfeitures.

(*Ridgley v. Topa Thrift & Loan Ass'n* (1998) 17 Cal. 4th 970, 981 fn.5.)

These principles, in force at the time the parties entered into the lease in 2004, are entitled to "super" *stare decisis* effect. First, "[w]here judicial decisions may be fairly presumed to have entered into the business transactions of a country, and have become established as rules of property, it is the duty of the court, on the principle of stare decisis, to adhere to such decisions without regard to how it might be inclined to decide if the question were new." (*Abbott v. City of Los Angeles* (1958) 50 Cal. 2d 438, 457 [internal quotation marks omitted].) Second, inasmuch as *Ridgley* involved the interpretation of the Civil Code, the California's Legislature's silence concerning that interpretation must be accepted as effectively definitive. (*People v. Latimer* (1993) 5 Cal.4th 1203, 1213 ["[T]he burden borne by the party advocating the abandonment of an established precedent is greater where the Court is asked to overrule a point of statutory construction. Considerations of stare decisis have special force in the area of statutory interpretation, for here, unlike in the context of constitutional interpretation, the legislative power is implicated, and Congress remains free to alter what we have done." (internal quotation marks omitted)].)

B. Commentators And Other Courts Applying California Law, Acting In Reliance On This Court's Teaching, Agree That Section 3275 Provides Relief From Contractual Penalties.

Section 3275 has been cited 300 times by trial and appellate courts. Miller & Starr list Section 3275 as one of the "[t]hree statute [that] may provide a basis for relief" from forfeiture. (Miller & Starr, *Relief from forfeiture* (4th ed., West 2022) 10 Cal. Real Est. § 34:224; *see also* 34 Cal. Jur. 3d Forfeitures and Penalties § 26.) So too does Rutter. (Rutter, *Postjudgment Motions*, Cal. Prac. Guide Landlord-Tenant Ch. 9:431.2.)

Grand Prospect's particular application of Section 3275 to co-tenancy provisions in retail lease agreements appears in Miller & Starr and Rutter as well. (Miller & Starr, *Landlord's covenant to retain other tenants* (4th ed., West 2022) 10 Cal. Real Est. § 34:112; Rutter, *Special "Problem" Provisions*, Cal. Prac. Guide Landlord-Tenant Ch. 2:394.20.)

Federal courts applying California law have had no difficulty recognizing the role of Section 3275 in general or *Grand Prospect* in particular. (*E.g.*, *Farina Focaccia & Cucina Italiana, LLC v. 700 Valencia St. LLC* (N.D. Cal. Feb. 27, 2017) No. 15-CV-02286-JCS, 2017 WL 745871, at *7; *Okada v. Whitehead* (C.D. Cal. Nov. 4, 2016) No. SACV151449JLSKES, 2016 WL 9448482, at *9 n.7, *aff'd*, 759 F. App'x 603 (9th Cir. 2019); *In re Fresh-G Rest. Intermediate Holding*, *LLC* (Bankr. D. Del. 2017) 580 B.R. 103, 109; *In re Premier Golf Properties, LP* (Bankr. S.D. Cal. 2016) 564 B.R. 660, 683-84.)

C. Jurisdictions Wth Similar Legal Traditions Regulate Contractual Penalty Provisions

All legal principles that require some judgment in their application occasionally provoke the ire of judges and litigants—it always seems life would be simpler with bright line rules like contracts must be enforced as written. Against the charge the rule against contractual penalties is unworkable or undesirable, the Supreme Court of the United Kingdom wrote:

> I come to Cavendish's primary and secondary cases, that the penalty doctrine should be abolished, or, that failing, that it should be restricted to non-commercial cases or to cases involving payment of money. I am unable to accept either proposition. . . . It has long been recognised that the situations in which the doctrine may and may not apply can involve making distinctions which can appear narrow and which follow lines which can be difficult to define. But that has never hitherto been regarded as a reason for abandoning the whole doctrine, which in its core exists to restrain exorbitant or unconscionable consequences following from breach.

(*Cavendish Square Holding BV v Talal El Makdessi* (2015) UKSC 67, 76 ¶ 162.) This same sentiment finds its apotheosis in Justice Holmes' admonition that "I do not think we need trouble ourselves with the thought that my view depends upon differences of degree. The whole law does so as soon as it is civilized." (*LeRoy Fibre Co. v. Chicago, M. & St. P. R. Co.* (1914) 232 U.S. 340, 354 [Holmes, J., concurring].) "Negligence is all degree,—that of the defendant here degree of the nicest sort; and between the variations according to distance that I suppose to exist, and the simple universality of the rules in the Twelve

Tables, or the Leges Barbarorum, there lies the culture of two thousand years." (*Ibid.*)

In support of its refusal to abandon the rule against contractual penalties, the Supreme Court of the United Kingdom noted that:

> the Scottish Law Commission pointed out (para 1.8) that there has been a general convergence of approaches in European civil codes and soft law proposals towards a recognition of the utility and desirability of judicial control of disproportionately, excessively, manifestly or grossly high or unreasonable penalties. The Council of Europe's Resolution 78(3) of 20 January 1978 on Penal Clauses in Civil Law (article 7), the Principles of European Contract Law (article 9:509), the Uncitral Texts on Liquidated Damages and Penalty Clauses (article 8) and the Unidroit Principles of International Commercial Contracts (article 7.4.13) all contain provisions for such control along such lines.
>
> I note in parenthesis that many national European legal systems already appear to contain similar provisions, even if only introduced legislatively as appears to be the case in France by laws of 9 July 1975 and 11 October 1985 amending article 1152 of the Code civil (and reversing the effect of the Cour de cassation decision in Paris frères c Dame Juillard Civ 14 February 1866).

(*Cavendish*, *supra*, 2015 UKSC 76, ¶¶ 164-65.)

Different jurisdictions may strike different approaches to contractual penalties as a matter of "degree," such as whether the loss must be grossly disproportionate or the like, but civilized jurisdictions all recognize the desirability of prohibiting contractual penalties.

D. Section 3275 Rather Than Section 1671 Should Govern the Penalty Analysis of Co-Tenancy Provisions.

Section 1671 is a specific instance of the general rule in Section 3275. Both sections ask the same fundamental question, whether there is "the lack of a proportional relationship between the forfeiture compelled and the damages or harm that might actually flow from the failure to perform a covenant or satisfy a condition." (*Grand Prospect*, 232 Cal.App.4th at 1358.) Section 1671, however, applies only to "a provision in a contract liquidating the damages for the breach of the contract," and differs from Section 3275 in that it presumes liquidated damages provisions in commercial contracts are enforceable. (Civ. Code § 1671, subd, (b).)

Grand Prospect had the opportunity to classify co-tenancy provisions in retail lease agreements as liquidated damages provisions. It did not do so, and there is no reason for the Court to disturb that choice, which is now integrated into the expectations of California landlords and tenants. But even if the Court considers the issue anew, co-tenancy provisions should not be treated as liquidated damages clauses.

Rather than a liquidated damages provision, which would apply if there had been a contractual breach that ended the relationship, most co-tenancy clauses, as with this one, assume the contract will continue. (*See, e.g.*, *Chodos v. W. Publ'g Co.* (9th Cir. 2002) 292 F.3d 992, 1002 ["According to Black's Law Dictionary, "[a] debt is liquidated when it is certain what is due and how much is due. That which has been made certain as to

amount due by agreement of parties or by operation of law." The term "liquidated debt" is similar to the term "liquidated damages," which the California courts have defined as "an amount of compensation to be paid in the event of a breach of contract, the sum of which is fixed and certain by agreement. . . ." (internal citations omitted)].) The sum due under a co-tenancy provision is neither fixed nor certain, as it cannot be known how long a default of the provision will last.

Co-tenancy provisions not only do not fit neatly within the traditional understanding of the term "liquidated damages," they *do* fit neatly into this Court's description of a penalty. A co-tenancy provision exists to incentivize—and in cases where it is too onerous, to compel—a landlord to undertake an act (re-renting an anchor space "or else") during the life of the agreement. That is exactly how a contractual penalty operates in this Court's description: "A penalty provision operates to compel performance of an act and usually becomes effective only in the event of default upon which a forfeiture is compelled without regard to the damages sustained by the party aggrieved by the breach." (*Garrett, supra,* 9 Cal.3d at 739 [citations omitted].) Here, for JJD, the "or else" is rent the available space for pennies on the dollar (assuming obtaining a replacement tenant is possible at *any* cost) to simply satisfy the co-tenancy provision with Jo-Ann, or suffer $30,000 a month in loss, despite the fact that Jo-Ann suffers **none**.

III. The Parties' Co-Tenancy Agreement Is Unenforceable

Whatever penalty-based analytic rubric the Court employs, whether Section 3275 or Section 1671, there can be little doubt that the co-tenancy provision in *this* case operates as a penalty and should be deemed unenforceable. Although courts are cautioned against the use of hindsight in assessing contracting parties' effort to quantify a future harm (at least in cases of liquidated damages), disputes in which there has been *zero* harm proven—or even an *effort* to prove harm—should constitute a special case. The total absence of harm should be treated as probative of the adequacy of the parties' effort to quantify it. Regardless, under even conventional analysis focused solely on the facts known at the time of contracting, JJD has affirmatively proven the loss it suffers under this co-tenancy bears no, and could not have been anticipated to bear, reasonable relationship to the harm to Jo-Ann.

A. This Co-tenancy Agreement Is Unenforceable Under Conventional Grand Prospect/Section 3275 Analysis

The undisputed facts establish that Jo-Ann has received a windfall penalty, paying less than one-third of the rent it owed in compensation for zero loss. That fact alone renders the parties' cotenancy agreement unenforceable as a matter of law. (*See Greentree Financial Group, Inc. v. Execute Sports* (2008) 163 Cal. App. 4th 495, 499-502.)

The test requires "the comparison of (1) the value of the money or property forfeited or transferred to the party protected

by the condition to (2) the range of harm or damages anticipated to be caused that party by the failure of the condition." (*Grand Prospect*, *supra*, 232 Cal.App.4th at 1358.) "If the forfeiture or transfer bears no reasonable relationship to the range of anticipated harm, the condition will be deemed an unenforceable penalty." (*Ibid.*)

At no point did the trial court or Court of Appeal conduct a "comparison of the value of the money" transferred to Jo-Ann by the co-tenancy agreement's rent forfeiture (over $30,000 per month) and "the range of harms or damages anticipated" by Jo-Ann from "violation" of the co-tenancy agreement. The closest either court came to this analysis was when the trial court wrote: "[T]he plain language of the Lease reflects that the Substituted [sic] Rent bears a reasonable relationship to the harm that JoAnn could suffer in the event JJD did not meet the requirements of" the co-tenancy clause. (AA 1029.) But the plain language of the lease nowhere reflects that a $30,000 per month reduction in rent bears a reasonable relationship to any actual damage to Jo-Ann. Indeed, when tasked with identifying the basis for the $12,000 or 3.5% of sales rent reduction (i.e. the measure of harm Jo-Ann would suffer as a result of a co-tenant's failure to open), Jo-Ann provided nothing.[7] (AA 466, [SS 35]; AA 468, [SS 40]; AA 490-491.) The trial court, in attempting to bypass the correct

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7 Perhaps Jo-Ann did not try to approximate damages because it knew that the failure of a co-tenant to open is unlikely to cause any harm to its business. One does not go to the grocery store for eggs then see Jo-Ann's next door and suddenly decide to pick up quilting.

analytical framework, apparently confused whether the parties ***negotiated a specific term*** with whether ***that specific negotiation was a reasonable effort to approximate damage.***[8] The former is undisputed and irrelevant, the latter is determinative and was entirely ignored.

Perhaps Jo-Ann opted against arguing Substitute Rent represents a reasonable effort to approximate damage by a failure of a co-tenant to open because the lease provides that Jo-Ann can pay Substitute Rent for wildly disparate and unrelated occurrences. Per the lease, Jo-Ann's suffers "damage" of approximately $30,000 per month (the difference between Fixed Minimum Rent and Substitute Rent) if a bowling alley, gun range, massage parlor, or church open near the shopping center. (AA 229.) This is the same measure of "damage" if a co-tenant fails to open. (AA 221.) There is no conceivable equivalence among these occurrences, yet the consequence to Jo-Ann's remains the same. This demonstrates Substitute Rent was not a reasonable effort to approximate damage upon an event's occurrence; it is a penalty to punish JJD for the failure of a condition outside its control.

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8 The existence of a negotiation cannot immunize a provision from a penalty analysis. For example, assume that instead of the provision at issue being labeled "CO-TENANCY" it was labeled "RAIN DAMAGE." And the latter provision provided a negotiated reduction of rent from $40,000 per month to $12,000 per month if it rained on any three consecutive Mondays after 7:15 p.m. in a calendar year. According to the trial court, so long as JJD and Jo-Ann negotiated the rent reduction, *ipso facto*, it is not a penalty.

When JJD argues Jo-Ann suffered no damage by the failure of the co-tenant to open, it does so because Jo-Ann failed to produce *any* evidence in the courts below of *any* harm from JJD's temporary failure. Indeed, Jo-Ann conceded this point, arguing on summary judgment that the "payment of reduced 'Substitute Rent' does not constitute an 'amount of damages' (or liquidated damages) to Landlord JJD, but rather a negotiated, agreed-upon tiered rental rate for the leasing of the commercial property." (AA 447.) But even if Jo-Ann had shown some kind of damage, more than $30,000 a month in loss to JJD-HOV—a 72% reduction in Jo-Ann's rent—cannot be proportional to Jo-Ann's non-existent loss, especially in light of the range of percentage reductions considered reasonable in prior cases

In any event, the undisputed facts establish that Jo-Ann has received a windfall penalty, paying less than one-third of the rent it owed in compensation for zero loss. That fact alone renders the parties' co-tenancy agreement unenforceable as a matter of law. (*See Greentree Financial Group, Inc. v. Execute Sports* (2008) 163 Cal. App. 4th 495, 499-502.)

While no precise formula exists to determine when a co-tenancy provisions in commercial leases constitute an uneforceable penalty. *Grand Prospect* held than a loss of $39,500 per month in the face of no alleged damages constituted an unenforceable penalty, and JJD's monthly loss of more than $30,000 per month today and more than $39,000 per month in the future is plenty close enough to that figure to fall squarely within the holding of that case. (232 Cal. App. 4th at p. 1338.) In

fact, JJD takes the position that *any* loss other than perhaps a token amount is unreasonable when no harm is alleged to have actually flown from a breach. But it does not need so broad a rule to win, as a review of the exhaustive survey of penalty-to-damages ratios in *Greentree Financial Group, Inc. v. Execute Sports* (2008) 163 Cal. App. 4th 495, reveals.

Greentree itself held a disparity of $61,232.50 to $20,000, or a ratio of 3.06 to 1, worked a penalty. (*Id.* at p. 500.) The ratio of JJD's current loss ($42,291.66 to $12,000) is even higher (3.52 to 1), and will only become more so as the Fixed Minimum Rent increases until the ratio tops out at 4.25 to 1 ($51,041.66 to $12,000). A one-time loss of $28,000—liquated damages of $100,000 for breach of promise to pay $72,000, or a ratio of 1.39 to 1—has been held unreasonable. (*Ibid* [citing *Sybron Corp. v. Clark Hosp. Supply Corp.* (1978) 76 Cal. App. 3d 896, 898].) Mere double rent—the less extreme flip side of this one-third to one-quarter rent situation—has been invalidated as a penalty. (*Id.* at p. 502 [citing *Harbor Island Holdings v. Kim* (2003) 107 Cal. App. 4th 790, 793].) Merely charging interest on an entire balance as opposed to just missed payments has been held to constitute a penalty. (*Ibid.* [citing *Garrett v. Coast & Southern Fed. Sav. & Loan Ass'n* (1973) 9 Cal. 3d 731, 740].)

The cases go on, but JJD trusts the point is made: there is no plausible argument that a penalty of more than $30,000 to nearly $40,000 per month bears or could have ever been thought to bear a reasonable relationship to $0 in damages. Even viewing the penalty here—Substitute Rent—simply as a percentage of the

Fixed Minimum Rent due rather than comparing it to the harm suffered reveals an unreasonable ratio of more than 3.5 to 1.

Against these points which are perceptible with the clarity of mathematical exactitude, all Jo-Ann could muster was the observation, accepted by the trial court, that none of these cases involved a co-tenancy provision. Except that is not true, as *Grand Prospect* was a co-tenancy case. And *Harbor Island Holdings v. Kim* (2003) 107 Cal. App. 4th 790, was a rent case.

More to the point, however, the range of acceptable ratios need not come from the same species of case. The question a penalty analysis asks is the reasonableness of the *relationship* between the penalty and anticipated harms. If a 3-to-1 relationship is unreasonable in, say, the settlement of two companies' financial services dispute (*Greentree*), there is no reason why it should magically become reasonable in two companies' commercial real estate dispute. It certainly does not stand to reason that a 3-to-1 ratio would be accepted for breach of any settlement agreement concerning rent in this case, where cases like *Greentree* can fairly be read to control. It would perversely disincentivize settlement to allow Jo-Ann to get away with a more unreasonable penalty via litigation than it could achieve through negotiated settlement of the dispute that led to the litigation. "California's public policy is to encourage settlement." (*Tower Acton Holdings v. Los Angeles Cty. Waterworks Dist. No. 37* (2007) 105 Cal. App. 4th 590, 602.)

B. This Co-Tenancy Agreement Is Also Unenforceable Under Section 1671

While neither JJD nor Jo-Ann have contended Section 1671 applies because neither avers there has been a breach of the contract, even if it did the result is the same. Section 1671 forbids against unreasonable contractual penalties, and there is one critical fact, perhaps unique to this co-tenancy provision, beyond the above, suffices to push this penalty provision past any presumption of reasonableness that might apply under Section 1671. That is the parties' use of "Substitute Rent" as a catch-all punishment for wildly disparate forms of potential harm. Presumably installing a missile manufacturing facility ("explosive or other hazard") or pig farm ("public or private nuisance") next to Jo-Ann would quite seriously impair its business. (AA 260.) Yet under the parties' agreement, the remedy is substantially the same as if a Planet Fitness opened 199 feet away from Jo-Ann's entrance (but not if it opened 201 feet away, which the lease permits) or there is a temporary failure of the co-tenancy clause. (*Compare* AA 252 *with* AA 260.) Jo-Ann intended and has since used "Substitute Rent" as a bludgeon to coerce performance, rather than some tailored effort to approximate harm. Twenty of years of conduct could not have made this clearer.

There is also no support of the Court of Appeal's apparent conclusion that unless the provision can be considered one of liquidated damages under Section 1671, then necessarily there can be no penalty. It rejected the rule of *Grand Prospect*, which is that a co-tenancy provision is an "uneforceable penalty unless

the reduction has a reasonable relationship to the harm the parties anticipated would be caused thereby." (Op. at p. 12.) It did so because "the rule is based on Civil Code section 1671, a statute governing the enforceability of contract provisions liquidating damages for breach of contract, and we find that statute to be inapplicable to the facts of this case because there is no suggestion that reduced occupancy in the shopping center resulted in JJD's breach of the parties' agreement." (*Ibid*.)

That is, the Court of Appeal appears to have held that because this isn't a case of liquidated damages based on Civil Code section 1671, then the provision necessarily cannot operate as a penalty. This Court, however, has never limited Section 3275's application to only those instances where there has been a breach of contract and liquidated damage thereto, and nor has the Legislature seen fit to amend section 3275 to specify the law's abhorrence of forfeitures is cabined to cases where section 1671 applies. To hold so now would be to put form over substance, permit penalties so long as they are "imaginatively drafted as contractual conditions," and thereby "condone which, although directly prohibited by the Legislature, may nevertheless be indirectly accomplished through the imagination of inventive minds." (*Garrett*, *supra*, 9 Cal. 3d at 737.)

This Court has consistently embraced a sweeping application of Section 3275 to ensure the equitable intent precluding forfeitures is furthered, irrespective of form. Holding otherwise now is inconsistent with this Court's near one-hundred year interpretation of Section 3275:

> Wherever a penalty or a forfeiture is used merely to secure the payment of a debt, or the performance of some act, or the enjoyment of some right or benefit, equity, considering the payment, or performance, or enjoyment to be the real thing intended by the agreement, and the penalty or forfeiture to be only an accessory, will relieve against such penalty or forfeiture by awarding compensation instead thereof, proportionate to the damages actually resulting from the non-payment, or non-performance, or non-enjoyment, according to the stipulations of the agreement. The test which determines whether equity will or will not interfere in such cases is the fact whether compensation can or cannot be adequately made for a breach of the obligation which is thus secured.' The same writer also declares that 'a court of equity will never, by its affirmative action, or by the affirmative provisions of its decree, enforce a penalty or forfeiture, or any stipulation of that nature.

(*Ebbert v. Mercantile Tr. Co. of California* (1931) 213 Cal. 496, 499 [citing *Pomeroy*] (emphasis added).)

Thus whether this co-tenancy provision is treated as a breach of contract, a liquidated damage clause under Section 1671, or a penalty pursuant to Section 3275, is frankly, irrelevant. This State should never, by affirmative action or decree, enforce a penalty or forfeiture, irrespective of what the provision is titled or the circumstances giving rise to it.

CONCLUSION

Jo-Ann has had every opportunity to explain to a court what harm it has suffered from the failure of the co-tenancy covenant. It has never done so, presumably because it has suffered no harm. Yet it wants a family-owned landlord to forfeit

huge sums because of the "inventive minds" of its lawyers in 2004. This the law of California does not allow and should not be changed to allow. JJD respectfully submits the judgment below should be reversed and rendered in its favor.

DATED: November 14, 2022

WHITNEY, THOMPSON & JEFFCOACH LLP

By: */s/ Jacob S. Sarabian*
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CERTIFICATE OF COMPLIANCE

Counsel of Record hereby certifies that pursuant to Rule 8.204(c)(1) or 8.360(b)(1) of the California Rules of Court, the enclosed brief of **PLAINTIFF-APPELLANT JJD-HOV ELK GROVE, LLC'S OPENING BRIEF ON THE MERITS** is produced using 13-point Century Schoolbook type including footnotes and contains approximately 11,231 words, which is less than the total words permitted by the rules of court. Counsel relies on the word count of the computer program used to prepare this brief.

DATED: November 14, 2022 WHITNEY, THOMPSON & JEFFCOACH LLP

By: *_/s/ Jacob S. Sarabian_*
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PROOF OF SERVICE

JJD-HOV ELK GROVE v. JO-ANN STORES, LLC
Case No. S275843

STATE OF CALIFORNIA, COUNTY OF FRESNO

At the time of service, I was over 18 years of age and not a party to this action. I am employed in the County of Fresno, State of California. My business address is 970 W. Alluvial Ave., Fresno, CA 93711.

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Executed on November 14, 2022, at Fresno, California.

/s/ Jacquelyn Bennett
Jacquelyn Bennett

Supreme Court of California
Jorge E. Navarrete, Clerk and Executive Officer of the Court
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STATE OF CALIFORNIA
Supreme Court of California

PROOF OF SERVICE

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Supreme Court of California

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Case Number: **S275843**
Lower Court Case Number: **C094190**

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