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Restrictive Covenants - the Life Cycle of a Shopping Center

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Restrictive covenants play a paramount role in the life of a shopping center. From the initial development of a shopping center to its later, inevitable redevelopment and recycling, customary restrictive provisions in leases and development documents can both protect and inhibit landlord and tenant efforts to survive in a constantly evolving retail industry. This article analyzes the evolutionary effect of restrictive covenants after the initial lease up of a shopping center. In the best of all worlds, a landlord will be able to make necessary changes in design, marketing and tenant mix to maintain a shopping center's competitive edge and, at the same time, grant sufficient flexibility for a tenant's business to evolve. Counsel for the landlord and the tenant will want to negotiate restrictive covenants that reflect this delicate balance. The initial restrictions will set the stage for the next generation in the life of a shopping center. Restrictive Covenants:

The First Generation

Today's regional malls, power centers, community strip centers and specialty centers rest on foundations of paper as well as concrete and steel. Aside from tenant leases, the most prominent documents supporting a shopping center are declarations and reciprocal easement agreements (CCRs). A developer often imposes these restrictions, but anchor tenants, other significant tenants whose leases are necessary for financing, adjacent property owners and lenders may also insist on them. In this article, unless otherwise indicated, references to "restrictions," "restrictive covenants" and similar terms will include both CCRs and lease restrictions. Generally, restrictive covenants address:

- The construction process, including architecture; parking ratios; building location, configuration, height, size, color and design; setbacks; on-and off-site signage; and landscaping.
- Use restrictions in the form of exclusives and radius clauses that limit or preclude certain protected retail uses for a minority of existing or proposed occupants.
- Other use restrictions prohibiting obnoxious or undesirable uses for the benefit of the landlord and all tenants of the shopping center.

Expansion and Redevelopment: The Second Generation

Over time, a shopping center may fall into a period of stagnation due to many factors, including the declining business of some of the existing tenants, changing market conditions or the landlord's inattention to needed repairs. Expansion or redevelopment may be necessary to give a shopping center a new life. In the second generation of the life of a shopping center, the same restrictions that protected the first generation of tenants and the developer may keep the shopping center from adapting to changed conditions.

To evaluate whether a shopping center expansion or redevelopment is feasible, the landlord must first review all existing CCRs and leases and pay particular attention to any covenants encumbering the shopping center. Express or implied covenants affecting the shopping center can limit expansion or redevelopment efforts in unpredictable ways. In evaluating the applicable restrictions, a landlord should consider several questions.

Do express restrictions prohibit the introduction of new tenants or new uses into the shopping center? Department store agreements may prohibit a landlord from replacing more traditional department stores with discount department stores or so-called "category killers." A lease or CCR may also prohibit certain kinds of users or uses. Additionally, key tenants may have successfully negotiated prior approval rights over leases of particular space in a shopping center. Alternatively, a developer may have negotiated clauses in which a retailer's change in use will terminate the retailer's exclusive use restriction or trigger a buy back right for the developer.

Do implied restrictions prohibit expansion and redevelopment? If a landlord does not have a specific right under applicable restrictions to change the nature of the shopping center, implied use restrictions may prevent it from converting a retail shopping center to another use. For example, implied use restrictions may arise from the attachment of a site plan or rendering to a lease or CCR, thereby prohibiting expansion beyond that depicted in these drawings. See, e.g., *Madigan Bros. v. Melrose Shopping Ctr. Co.*, 463 N.E.2d 824 (Ill. Ct. App. 1984); *Safeway, Inc. v. Plaza Co.* 444 S.E.2d 544 (Va. 1994). Attachment of a site plan may also create implied representations that the buildings and improvements will not change or that certain tenants will be present during a particular tenant's lease. Other implied restrictions that may inhibit redevelopment or expansion are:

- The designation of common areas, or a duty to pay for common area maintenance or repairs and replacements, each of which may create access, visibility, parking and similar easements.
- The covenant of quiet enjoyment, which can restrict interruption and inconvenience from construction.
- A definition of the "premises" that incorporates appurtenant rights, which may create implied covenants for existing access and visibility.
- A definition of the "shopping center" that excludes expansions, which can prevent the developer from expanding the shopping center or allowing tenants on adjacent land to share existing common areas.
- A definition of the "shopping center" that includes outparcels or after-acquired properties, which may subject those properties to existing restrictions imposed on the "shopping center." See, e.g., *Slice v. Carozza Properties, Inc.*, 137 A.2d 687 (Md. 1958). Do other express or implied restrictions limit expansion and re-development efforts? Construction restrictions can limit expansion or redevelopment goals, such as:
 - "no build" or "permissible building" areas;
 - provisions limiting the use of shopping center common areas, such as parking lots, for any purpose other than as originally designated;
 - parking ratio requirements for different uses; and
 - other prohibitions against interference with existing access, visibility, use or enjoyment. In addition, anchor and other important tenants may have negotiated controls over parking areas near their premises. Before expansion or redevelopment, the landlord must ascertain the following:
 - Are there any express covenants or representations about the size or configuration of parking lots or access points?
 - Can any party claim implied covenants or conditions on parking or traffic flow because site plans were attached as exhibits or because the developer has complied with code requirements that subsequently have been modified or superseded?

Restrictive Covenants in Leases

Integral to the success of both first and second generation shopping center development is the negotiation of a meaningful and comprehensive exclusive use restriction program for the shopping center. A tenant deciding to lease space in a second generation shopping center bases its decision on many factors. One of the most important factors is the correct retail mix. The tenant wants to ensure that other stores with compatible covenants are open and operating, resulting in a favorable synergy among all shopping center tenants. In addition, the tenant may want to minimize the potential for direct competition with its primary

line of business as well as other significant aspects of its use. Managing a retail development subject to numerous exclusives and restrictive covenants can be a problem for the landlord if it permits conflicts to exist in the exclusives it grants to different tenants, or if a tenant obtains too broad an exclusive, thereby preventing a future lease to another retailer that would add value to the shopping center. Landlords must be particularly vigilant in defining the parameters of tenants' use rights, especially if the use clauses are permissive and allow for ongoing changes in the tenants' lines of business.

Lease provisions that allocate the risk of confirming whether a second generation lease complies with the relevant restrictive covenants may be found in an integrated lease clause or as part of clauses addressing title, quiet enjoyment and use rights. Landlords and tenants try to allocate this risk to each other. Sample competing lease clauses accompany this article.

To minimize the potential for creating inconsistent or conflicting restrictions, a landlord should maintain a catalog of current restrictive covenants. The landlord's counsel can then better evaluate whether a prospective tenant's use and improvements comply with these restrictions. Similarly, counsel must determine whether the landlord can restrict existing tenants under the terms of any new restrictions required by the prospective tenant. The first tier of this analysis is more practical, relying on basic questions such as:

- What is restricted and how is it defined? Does the restriction apply to a certain type of retail operation (e.g., deli, drugstore or convenience store)? What products are restricted? Does the restriction apply to an expansion of the shopping center?
- What is the scope of the restriction? Is it an absolute prohibition? Are there any permitted exceptions? For example, is the use restricted on a primary or incidental basis? If so, is primary or incidental use defined by sales volume, display area or some other means?
- Does the restrictive covenant contain an expiration or forfeiture provision? Will nonuse forfeit the restriction or exclusive? Is continued enjoyment conditioned on the absence of a default by the beneficiary?

This first tier analysis focuses on the scope of the restrictions potentially affected by the proposed tenancy. Landlord's counsel should perform a similar analysis of the use clauses of the existing tenants to assess which tenants could, by their permitted uses, violate the exclusive sought by the prospective tenant. This second tier of analysis requires an understanding of the judicial construction of restrictive covenants. Generally, courts construe restrictive covenants narrowly, with all doubt resolved against enforcement. See, e.g., *Rite Aid, Inc. v. Marc's Variety Store, Inc.*, 638 N.E.2d 1056, 1060 (Ohio Ct. App. 1994); *Sampson Investments v. Jondex Corp.*, 499 N.W.2d 177 (Wis. 1993). The parties' intent at the time they entered into the contract is often used to define restricted items, particularly in older leases when industry changes raise questions about the meaning or scope of a restriction. Courts have emphasized that precision and definition are critical to avoid judicial interpretation of the parties' intent.

Generally, if a lease provides that the demised premises shall be used "solely" or "only" for a particular use or purpose and "for no other use or purpose," courts will enforce such a restriction. If the lease does not exclude other purposes, the use clause will likely be considered as permissive and will not prevent the tenant from using the demised premises for some other purpose. To determine whether a lease provision is descriptive or restrictive, some courts will look at surrounding circumstances, such as a course of dealings between the parties and the format of the particular trade or line of business at the time of lease execution.

Courts may find that restrictions using the terms "primarily" or "principally" are ambiguous and may not enforce them in the manner that the parties intended. In *Walgreen Co. v. Sara Creek Property Co.*, 775 F. Supp. 1192, 1195-96 (E.D. Wis. 1991), *aff'd*, 966 F.2d 273 (7th Cir. 1992), the court found that the phrase "principal portion" was ambiguous because it was neither "plain

on its face" nor defined in the lease. The court found no persuasive evidence of the parties' intent and used a dictionary definition of "principal" to determine that it was synonymous with "main" or "chief in size or extent." Id. at 1196.

Narrow use restrictions may be vulnerable to other unanticipated results. For example, in *Marriott Corp. v. Combined Properties Limited Partnership*, 391 S.E.2d 313, 314 (Va. 1990), the tenant operated a Roy Rogers restaurant and sought to prevent other similar restaurants from competing in the shopping center. The lease language prohibited other "drive-in" restaurants, which was the predominant form of competition when the lease was signed in 1967. Id. at 314-15. The court determined that the prohibition of drive-in restaurants did not restrict another fast food restaurant whose business was at least half dine-in (with the rest split between drive-through window and carry-out patrons). Id. at 315-16.

Counsel should supply further definitions when using terms such as "principal" or "primary" to describe a restriction or permitted use. As the *Marriott* case illustrates, counsel should consider the likelihood of the tenant's use evolving over the term of the lease and, if possible, provide for that change. See also *Cox v. Ford Leasing Dev. Co.*, 316 S.E.2d 182 (Ga. Ct. App. 1984); *Sky Four Realty Co. v. C.F.M. Enters., Inc.*, 513 N.Y.S.2d 546 (N.Y. App. Div. 1987); *MBD Enters., Inc. v. American Nat'l Bank*, 655 N.E.2d 1061 (Ill. Ct. App. 1995).

Whenever possible, landlords should agree to a narrowly tailored exclusive for a particular type of "product" rather than a type of "store." The parties should resolve whether the tenant's proposed exclusive will be subject to actual existing uses or the contractual use clause provisions. Depending on the circumstances, actual uses may be broader than the contractual uses or contractual uses may be more expansive than the actual uses. **Additional Leasing Concerns**
Landlords and tenants in the second generation of the shopping center can encounter additional leasing concerns.

- **Right to change use/failure to operate.** The tenant must determine the effect a change in its business or permitted use will have on its exclusive, including a lapse of the exclusive. Additionally, the tenant will not want a change in its use to be subject to a "de facto" exclusive—that is, a covenant prohibiting a tenant from changing its use if the new use conflicts with any other tenant's then-current use, whether or not that other tenant actually has an exclusive for that use. A tenant's breach of an express operating covenant may void the tenant's exclusive. Other lease clauses, unrelated to express operating covenants, may create implied covenants of continuous operation. Counsel should draft continuous operating covenants with clear, plain language to avoid any inferences or assumptions. A landlord and tenant should negotiate whether restrictive covenants are waived if the tenant no longer operates in the shopping center.

In *Jondex*, the lease gave the tenant a supermarket exclusive and required it to occupy and use the premises only for a retail warehouse store selling articles found in family centers and supermarkets. *Jondex*, 499 N.W.2d at 179. The tenant ceased operations but continued to pay rent. The court held that the lease clause was a restrictive use clause and not a continuous occupancy clause because the clear language of the clause did not require the tenant to operate continuously. Id. at 183. In contrast, in *East Broadway Corp. v. Taco Bell Corp.*, 542 N.W.2d 816 (Iowa 1996), Taco Bell was a successor lessee under a lease with no written covenant to operate continuously but with a percentage rent clause. Taco Bell closed its business and paid only its low base rent. In ruling for the landlord, the court stated that a covenant of continuous operation will be implied if a substantial part of the rent is a percentage of gross sales. Id. at 819. The court found that the rent was derived substantially from Taco Bell's gross sales. Id. at 821.

- Obnoxious uses. A landlord and tenant must also consider restrictions on various disfavored uses and other circumstances such as:
 - Changes in the environment and conditions from earlier development of the shopping center, changes in the industry and the natural evolution of products.
 - Whether the lease provisions are drafted to incorporate future concepts in commercial real estate, such as off-track betting, upscale pool halls, secondhand retailers and new entertainment-related concepts (which may otherwise fall into categories of undesirable uses).
 - Retail uses that affect parking requirements, including entertainment facilities such as restaurants and theaters, and nonretail uses, such as educational activities and training classes.
 - Site plan control. The tenant may seek to negotiate certain control rights over the common areas, such as:
 - Changes to common or building areas and whether the tenant's consent may be required for that kind of change, as compared with a "no build" area for a certain part of the shopping center. See, e.g., *Safeway*, 444 S.E.2d 544.
 - Modification of key areas, view corridors, no build areas and access areas.
 - Use of common areas other than mutual, nonexclusive uses.
 - Necessary changes. The landlord and tenant may need to negotiate restrictive covenants for building location, height, theme and signage. The landlord will seek to retain total control while the tenant will want certainty and predictability concerning the character of the shopping center.
 - Multiple ownership/after-acquired property. A tenant's requested restriction or exclusive may not obtain the desired effect if the landlord does not own all or substantially all of the shopping center or later acquires more property to add to the shopping center. In *Edmond's of Fresno v. MacDonald Group, Ltd.*, 217 Cal. Rptr. 375, 376-77 (Cal. Ct. App. 1985), a lease provided that there would be only two retail jewelry stores in the shopping center. The court held that the restriction applied to a newly developed portion of the shopping center under an implied covenant of good faith and fair dealing, which requires that neither party do anything to deprive the other of the benefits of the agreement. *Id.* at 379-80. See also *Slice*, 137 A.2d 687.
 - "First class" manner. A lease restriction might provide for the landlord or tenant to operate the shopping center or premises in a "first class manner." This may create a problem. When drafting this kind of provision, counsel should include clear standards for the restriction and state which party determines the standard. For example, the standard may be tied to other shopping centers in the geographical area or the condition that existed at lease execution or possession of the premises, and the determination could be based on either the landlord's commercially reasonable judgment or sound property management standards.

Remedies for Breach

A landlord may not know that a tenant's exclusive rights have been breached until the tenant demands that the landlord enforce the exclusive rights or be faced with tenant remedies for that violation. Possible remedies include an injunction, damages, a rent adjustment or abatement or a lease termination.

In *Walgreen*, Walgreen obtained a permanent injunction to enforce its exclusive for a "drug store or a so-called prescription pharmacy or for any other purpose requiring a qualified pharmacist." *Walgreen*, 775 F. Supp. at 1194, 1198. The court, however, found that neither a typical Phar-Mor store nor the store Phar-Mor proposed to open in the same shopping mall would violate Walgreen's other exclusive that prohibited "the operation of a business the principal portion of which is the sale of so-called health and beauty aids and drug sundries." *Id.* at 1196-97. The court

stated that the choice between an injunction and damages requires a balancing of costs and benefits. *Id.* at 1197.

In *Child World, Inc. v. South Towne Centre, Ltd.*, 634 F. Supp. 1121, 1123-24 (S.D. Ohio 1986), a restrictive covenant in a lease barred the landlord from selling property to another toy store within a specified radius. The court found the restriction valid against the landlord. *Id.* at 1135. The court applied a balancing test that weighed the tenant's right to enforce the covenant against the damages that the tenant would have sustained if the landlord sold to a competitor. *Id.* at 1126. In reaching its decision, the court reasoned that the landlord would not suffer unreasonable hardship because it could sell or lease to someone else.

Short of a judicial determination, the parties may not be able to conclude with any reliable certainty the scope of a restrictive clause. Accordingly, counsel should be prepared to advise a client on the consequences of a violation of the restrictive covenant. This discussion should include the remedies available to the beneficiary in the contract, at law and in equity and the parties that are liable for the breach. Even though a landlord negotiates sound use clauses and exclusives and polices them, the landlord should also limit the tenant's remedies for exclusive rights violations to maximize the landlord's flexibility in leasing the shopping center. For example, if a violation occurs, the lease could allow the landlord to buy out the tenant at a predetermined amount (e.g., the unamortized cost of the tenant's leasehold improvements less any improvement allowance funded by the landlord).

Existing tenants must also be watchful of new tenants and diligently protect their own exclusive rights. Courts are receptive to arguments that a tenant should lose its exclusive if it fails to timely enforce its rights. In *J.C. Penney Co. v. Giant Eagle, Inc.*, 813 F. Supp. 360, 371 (W.D. Pa. 1992), *aff'd*, 85 F.3d 120 (3d Cir. 1996), Giant Eagle claimed that Penney unreasonably delayed in asserting a breach of its drugstore exclusive while Giant Eagle installed a pharmacy in its store. The court stated that the affirmative defense of laches may bar such a claim if the plaintiff's delay in bringing suit was unreasonable and the defendant was prejudiced by the delay. *Id.* at 372. Giant Eagle was unable to meet the burden of proof necessary to sustain the defense. The court relied on Giant Eagle's prior knowledge of the restriction, as well as Penney's repeated refusals to waive the restriction and Penney's notice to Giant Eagle of its objection before construction began.

In *Piggly Wiggly of Mansfield, Inc. v. Wolpert Associates*, 519 So. 2d 371 (La. Ct. App. 1988), *cert. denied*, 522 So. 2d 1098 (La. 1988), a supermarket tenant sought to enjoin Wal-Mart from violating Piggly Wiggly's supermarket exclusive. The court refused to enforce the tenant's exclusive rights, relying on the tenant's execution of a "clean" estoppel certificate at a time when it had firsthand knowledge of Wal-Mart's sale of grocery items. *Id.* at 373.

Conclusion

Restrictive covenants can and often do have a significant effect on the life of a shopping center. Restrictions that are not carefully considered and drafted may not ultimately protect the interests of either party as originally intended. It is often difficult to predict the evolution of retailing concepts and trends and to provide adequately for these contingencies in leases and other development documents. Nevertheless, the ability of lawyers for the landlord and tenant to do so can determine whether a shopping center, or a particular tenant's business, will survive into old age or become extinct before reaching its true potential.

Landlord Form

(a) Landlord covenants that, if Tenant performs all of the covenants of this Lease to be performed by Tenant, Tenant shall have, hold and enjoy quiet possession of the Demised Premises for the Term without hindrance or interruption by Landlord or any other person or persons claiming

under Landlord, subject to: (i) the terms of this Lease, (ii) all matters of record and (iii) any restrictive covenant now or hereafter granted to any other tenant or occupant of the Shopping Center.

(b) Tenant's exclusive under Section _____ is subject to all existing tenancies.

Tenant Form

(a) Landlord covenants that, if Tenant is not in default of its obligations under this Lease beyond the applicable cure period, Tenant shall have, hold and enjoy quiet possession and use of the Demised Premises as herein provided. Without limiting the foregoing, Landlord covenants that (i) the Declaration of Restrictions encumbering the Shopping Center permits, or Landlord shall cause it to permit, each provision of this Lease, and (ii) Tenant shall not be prevented from or restricted in constructing Tenant's improvements under Section _____ or offering the goods and or services permitted under Section _____ (use clause), because of any private restriction, covenant or agreement now or hereafter granted to any other tenant or occupant of the Shopping Center. (b) Tenant's exclusive under Section _____ shall restrict all operations in the Shopping Center during the term hereof, excluding only the following: _____.

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