Commercial Restrictive
Use Covenants

By

Jerry Kindinger

Ryan, Swanson & Cleveland, PLLC
1201 Third Avenue, Suite 3400
Seattle, WA 98101-3034

September 3, 2008
Seattle, Washington
Synopsis

To maximize the value of restrictive use covenants, draftsmen should be specific, detailed and clearly express the parties’ full intent, leaving as little as possible for later guesswork by others. This article presents recent cases interpreting various restrictive covenants, provides some drafting suggestions for achieving better protection for clients and avoiding potential pitfalls, and finally provides a handful of exemplars to illustrate some approaches used recently by lawyers to maximize the intended benefits of the restricted use provisions of their clients’ leases.
I. INTRODUCTION

Restrictive covenants have long played a crucial role in commercial developments. The subject matters of restrictive use covenants are wide ranging. Ideally, they ensure long-term stability in multi-tenant developments and protect the property investments of landlords and tenants alike.

Restrictive covenants are most commonly contained in development agreements such as reciprocal easement agreements, Covenants, Conditions and Restrictions (“CCRs”), leases and sometimes triparty agreements. Unless otherwise indicated, reference to restrictions, restrictive covenants and similar terms will include all of these development agreement forms.

Few covenants in commercial developments are more important than use restrictions. In the best of all worlds, these clauses enable a project owner to develop and retain a tenant mix which maintains the competitive edge of the project, thereby enhancing its overall value, and ensures tenants protection for certain specified uses and a favorable synergy among other tenants, leading to more profitable business operations.
II. TYPES OF USE CLAUSES IN COMMERCIAL PROJECTS

The purpose of use clauses is to define or limit the use to which a tenant may put leased premises or to limit the ability of the landlord to enter into other leases antithetic to a particular tenant’s interests. There are two general types of use provisions contained in commercial development agreements.

Purpose and use clauses affirmatively set forth the purposes for which the premises can be used. Uses may be described in general or specific terms. General descriptions set out the type of business permitted to be conducted on the premises. They may or may not bar the tenant from conducting other activities as well. They may be exclusive or permissive. That is, the use clause may grant exclusive rights to a tenant to conduct certain activities on the premises to the exclusion of any other tenants in the shopping center or development; or, provisions may merely provide permission or approval of the tenant to conduct such activities without any rights of exclusivity. Specific use provisions tend to describe particular services or activities permitted or products to be sold in detail.

The second type of use provision is an exclusionary clause which identifies particular activities or uses in which the tenant is prohibited from engaging on the leased premises. Exclusionary covenants are also obtained by tenants from landlords to prohibit activities or leases being entered into by the landlord in other portions of the development. These would often include, for example, uses which utilize significant parking, such as schools, spas and movie theaters or uses considered offensive such as adult bookstores or nightclubs.
III. PRINCIPLES OF JUDICIAL CONSTRUCTION

Litigating restrictive uses is an uncertain course. Litigation often arises because of a lack of clarity by the draftsmen. Once referred to a court for judicial resolution, the outcomes become unpredictable, even in the face of commonly applied rules of construction and/or commonly accepted legal principles. Below are ten commonly expressed principles often found in reported cases and frequently yielding opposite conclusions in substantially similar cases:

1. A lessor may restrict the use of a demised premises provided the restrictions are reasonable and not in restraint of trade or otherwise against public policy. See generally 86 ALR 4th 259 (1991).


3. The scope of a restricted use covenant, where not otherwise clear, is determined based upon the parties’ intent at the time the lease was signed. Thrifty-Payless, Inc. v. Ennen Food Stores, Inc., 113 Fed. Appx. 797, 800 (9th Cir. 2004).


5. Covenants that premises shall be used for a specific purpose do not impliedly forbid their use for a similar lawful purpose that is not injurious to the rights of landlord. Vereen v. Hargrove, 96 S.W.3d 762, (Ark. Ct. App. 2003). However, when landlords covenant that an entire project is intended to be used for a specific commercial
purpose, such restrictions are enforceable by tenants. See Herman Miller, Inc. v. Thom Rock Realty Company, L.P., 46 F.3d 183 (2d Cir. 1995) (covenant that center intended for use as showrooms and related uses enforced against landlord).


7. Wherever possible, a lease should be construed reasonably and in such a manner as will be most equitable to the parties and give neither an unfair advantage over the other. Id.

8. Generally, if a lease provides the demised premises shall be used “solely” or “only” for a particular purpose and “for no other purpose,” courts will enforce such a provision.


10. Any exclusive use granted to a tenant may be deemed void if the tenant discontinues the exclusive use for a specified period.
IV. THE PROBLEM/CHALLENGE

Life is dynamic. Businesses evolve. Needs of parties change. Major changes in retailing formats have occurred in recent years. Product lines and services have expanded so that individual enterprises themselves have become one-stop mini shopping centers. Grocery stores offer banking, real estate, and pharmacy services. They sell automotive accessories and other hard goods in addition to food. Drugstores sell apparel, film developing, sporting goods, food and other items wholly unrelated to the business of pharmacy operations. Today, distinctions between shopping center tenants have become blurred. This evolution requires lawyers for owners to develop new approaches for controlling or limiting tenant uses; and, similarly, for tenants’ attorneys to clearly carve out protections for their clients’ products and long-term business interests.

Counsel for tenants and landlords alike need to anticipate and provide for evolution of their clients’ businesses. In addition, counsel for commercial landlords need to also plan for changes in the use of their property over time and build in flexibility into the leases and other development agreements to meet future, albeit unknown needs. Failure to do so may leave parties on both sides saddled with inflexible restrictions drafted at a time years earlier which no longer serve the interests of one or the other or the successors of either.

Negotiating and drafting clear use restraints between landlords and tenants, often with conflicting priorities, is more art than science. Trying to make such provisions lastingly relevant and applicable to unforeseen changes further increases the lawyer’s challenge.

There is no easy or single solution to the challenge of effective draftsmanship of use restrictions, but there are some general drafting techniques to keep in mind. The
cardinal rule is to be as specific and detailed as you can in defining the parties’ use restrictions. No better time exists to spell out the parties’ intent than during the negotiations and drafting of the lease. Doing so clearly will diminish the likelihood that a judge at some future date will be called upon to try to interpret an unexpressed intent of the parties. The following are some suggested dos and don’ts in drafting use restrictions.

A. Suggested Don’ts

1. **Undefined Generic Business Descriptions.** Generic terms such as an “exclusive right to operate a drugstore” or a “grocery store” should be avoided. The concept of the nature of the business done by these types of businesses has materially changed over the years. Failure to account for future evolution may miss the interests intended to be protected.

2. **Undefined Modifiers.** Such terms as “principally” or “primarily” or “related items” lack precision and may be found to be ambiguous and of little help in subsequent efforts to determine the parties’ intent. *Walgreen Co. v. Sara Creek Property Co.*, 775 F. Supp. 1192, 1195-6 (E.D. Wis. 1991). Use of these terms should be avoided.

3. **Unexplained Conditions.** A lease restriction might require a landlord or tenant to operate the shopping center or premises in a “first class” manner without identifying some objective or recognized standard by which the parties or the court can later measure compliance is problematic. Counsel should include clear standards for the restriction and identify which party determines the standard. *See Hawkins, Delafield & Wood, LLP v. RBNB 67 Wall Street Owner LLC*, 7 Misc.3d 753, 794 N.Y.S.2d 888 (2005) (covenant to “run as a first class building” did not restrict landlord from converting office space to residential use).
4. **Words of No Legal Significance.** A clause stating that no change of use may occur without the prior written consent of the landlord is virtually meaningless because it gives the tenant no right that does not already exist. *E.g. Chapman v. Katz*, 448 Mass. 519, 521, 862 N.E.2d 735 (2007) (absence of legally cognizable reason to withhold covenant held insufficient to bar tenant’s change of use).

5. **Uncontrollable Events.** Avoid drafting exclusive use provisions which the landlord cannot control or enforce – example: “No other stores selling food products for off-premises consumption shall be operated in the shopping center.” Such a provision could put the landlord in breach of its lease with a tenant, if another tenant commences selling such products when such use is not specifically prohibited in its lease.

**B. Suggested Dos**

**Landlord Considerations**

Landlords may consider limiting exclusivity clauses by any of the following:

1. Exclusive provisions in a multi-tenant development must be integrated. For example, an exclusive must be subject to rights of existing tenants and, thereafter, all future leases must prohibit the exclusive use. Thus, if agreeing to exclusive uses or rights to sell product include a generic exception for the rights of any preexisting tenants. Example: “Landlord will not hereafter execute any lease that permits the tenant thereunder to operate as a [identify]” or “Tenant shall have the exclusive right to operate a [identify] in the shopping center subject only to the rights of [list of existing tenants without use restrictions].”

2. Provide for loss of exclusive rights granted to tenant if the tenant discontinues exclusive use for a specified period of time.
Example:

11.4.1 Termination of Competitive Business Covenant, The restrictions against the sale of food for off-premises consumption contained in this Article 11 shall terminate and be of no further force or effect if, after the commencement of the Original Term, a grocery store is not operated in the Leased Premises for a continuous period of twelve (12) months or more for any reason other than (i) a strike, lockout or other labor difficulty, fire or other casualty, condemnation, war, riot, insurrection, act of God, the requirements of any local, state or federal law, rule or regulation, or any other reason (other than financial) beyond the reasonable control of Tenant or (ii) temporary closure due to the restoration, reconstruction, expansion, alteration or remodeling of the Leased Premises, The restriction against the sale of Prescription Pharmacy Merchandise contained in this Article 11 shall terminate and be of no further force or effect if (i) Tenant does not sell Prescription Pharmacy Merchandise from the Leased Premises within twenty-four (24) months following the commencement of the Term for reasons other than those set forth in (i) and (ii) of the previous sentence, or (ii) if, after Tenant commences to sell Prescription Pharmacy Merchandise from the Leased Premises, Prescription Pharmacy Merchandise is not sold in the Leased Premises for a continuous period of twelve (12) months or more for any reason other than those set forth in (i) and (ii) of the previous sentence. Such restrictions shall again be effective if Tenant thereafter operates a grocery store in the Leased Premises or thereafter sells Prescription Pharmacy Merchandise from the Leased Premises, but shall be subject to any leases, assignments or subleases entered into during the period that such restrictions were not effective.

3. Limit exclusive uses to particular types of business operations rather than particular types of products. A generic landlord exclusive use form may look like this:

Exclusivity. Landlord shall not use or allow any other person or entity (except Tenant) to use any portion of the Property for the sale of (a) freshly ground or whole coffee beans, (b) espresso or espresso-based coffee drinks or coffee-based drinks, or (c) gourmet, brand-identified brewed coffee. This restriction shall also apply to kiosks and carts. The foregoing restriction shall not apply to the grocery store premises currently operated as ________ (the “___________ Store”) so long as: (i) the ________ Store is operated as a grocery store; or (ii) the tenant of the ________ Store as of the date hereof (the “Current ________ Tenant”) or its assignees or sublessees changes the use of the ________ Store in accordance with the

Tenant Considerations

1. Request exclusive rights to sell specific products.  See, e.g., Buford-Clairmont Co. Ltd. v. Radioshack Corp., 622 S.E.2d 14, 17 (Ga. Ct. App. 2005) (exclusivity clause granted to tenant prohibiting leases to any other tenant for use in retail sale or display of electronic equipment or components held enforceable).

2. Alternatively, consider a covenant in which the landlord will not lease to any other tenant whose principal business is the same as the tenant.  But if this is done, define what is intended by principal business.  This can be done in various ways, including gross revenues, shelf space, products, etc.  See, e.g., MBD Enters. v. Am. Nat’l Bank, 655 N.E.2d 1061, 1063 (1995) (yogurt sales of 15% of tenant’s business did not violate exclusivity granted by landlord against leasing to another tenant whose “principal business” was yogurt sales”).

A generic tenant exclusive use paragraph might provide:

(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 other tenants’ operations in the Shopping Center during the term hereof, excluding only the following: ________________
V. CHANGE OF USE CLAUSES

Consideration of whether to provide for a change of use during the lease term should be given in all commercial developments. Assuming the parties are willing or interested in creating some opportunity for later change in use, then care should be undertaken to do so meaningfully, identifying the factors and/or circumstances under which a tenant’s use may be changed.

Many leases contain provisions to the effect that a tenant’s use cannot be changed without the landlord’s “prior written consent which shall not be unreasonably withheld.” While requiring the landlord to be reasonable gives the tenant some bargaining power, the bare bones nature of the provision can invite debate and litigation over the reasonableness of the landlord’s rejection. See e.g. Ernst Home Ctr. v. Sato, 80 Wn. App. 473, 910 P.2d 486 (1996) (whether landlord unreasonably withheld consent to assignment held question of fact).

More helpful variations of change of use provisions might require the landlord to consent to a change of use if specified conditions were met. Examples: changes permitted that are limited to certain categories of uses, such as retail business or use not in conflict with any then existing use in the shopping center; requirements that tenants pay for the costs of any additional insurance premiums related to proposed new uses; requirements that no use present additional risks of environmental contamination; or a limitation on the number of times that the use can be changed.
VI. CREATIVE TENANT ENFORCEMENT REMEDIES

Commercial tenants sometimes create adverse economic consequences for landlord violations of exclusivity provisions. Such provisions are generally in addition to any other remedies the tenant may have in equity or law. These remedies can include rent abatement and lease termination and provide a self-executing enforcement mechanism to ensure the tenant exclusivity rights are maintained. Some examples of these are set forth below:

11.3.1 Enforcement of Competitive Business Covenant, The parties agree that the economic loss to Tenant resulting from a violation of this Article 11, is not readily measurable, or subject to precise calculation. Accordingly, in the event of a violation of the provisions of Section 11.2., then, in addition to Tenant’s right to seek other remedies as provided in Section 17.5., Tenant’s obligation to pay Rent shall be abated, as long as such violation continues, by an amount equal to fifty percent (50%) of the Rent. If the violation has not been corrected within one hundred eighty (180) days after Landlord’s receipt of Tenant’s notice, Tenant, at its option, may terminate this Lease by written notice to Landlord. Landlord and Tenant agree that, in any lawsuit by Tenant seeking specific performance of the terms of this Article 11, by injunctive relief, the harm suffered by Tenant by reason of a breach of Section 11.2., shall be deemed to be irreparable for which, Tenant does not have an adequate remedy at law. In no event shall Tenant be required to post a bond or other security in any action seeking to enforce the provisions of Section 11.2. by injunctive relief or other remedy.

* * *

If one or both of these covenants be broken, one-half (1/2) of all payments required to be made by Tenant under this Lease shall be abated for so long as such breach continues. The total sums so abated shall be liquidated damages for such breach and not a penalty, the parties agreeing that Tenant inevitably must sustain proximate and substantial damages from such breach, but that it will be very difficult, if not impossible, to ascertain the amount of such damage. In addition to this remedy, Tenant shall be entitled to injunctive and other appropriate relief, whether under the provisions of this Lease or otherwise.
VII. RADIUS CLAUSES

Powerful commercial tenants can demand and often receive exclusivity covenants from landlords beyond the leased premises or land area covered by CCRs. The following is an example of a very specific covenant in favor of a restaurant chain tenant:

Covenant Not To Compete and Setback Restriction: Landlord covenants and agrees that no property (other than the Demised Premises) now or hereafter owned, leased or controlled, directly or indirectly, by Landlord or, if Landlord is a corporation, any subsidiary of Landlord, adjacent or contiguous to the Demised Premises or within two (2) miles of the perimeter of the Demised Premises (whether or not such other property is subsequently voluntarily conveyed by Landlord) shall, during the term of this Lease and any extensions, be leased, used or occupied as a restaurant, food service establishment, drive-in or walk-up eating facility, collectively termed as a “restaurant”. The term “restaurant” as used in this clause shall apply to any type of food service establishment which serves an amount of any of the following products:

Hamburgers or any other type of beef products served in sandwich form;
or

Ground meat or meat substitute, or a combination of ground meat and meat substitute, or any other type of meat products, any of which are served in sandwich form;

Chicken;

Pizza or Pizza Bread;

Eggs or egg substitutes, pancakes, french toast, cereal or waffle products;

Tacos. Burritos, Tamales, Enchiladas, Fajitas or Nachos;

Fish;

Ice Cream;

Frozen Yogurt;

Cookies.
In addition, and by way of example, the following restaurants operating under the listed trade names, or operating under any successor trade names, are prohibited within the areas, and for the time period specified in this Article.

<table>
<thead>
<tr>
<th>Arby’s</th>
<th>Fuddrucker’s</th>
<th>Ponderosa</th>
</tr>
</thead>
<tbody>
<tr>
<td>Big Boy</td>
<td>Hardee’s</td>
<td>Popeye’s Chicken</td>
</tr>
<tr>
<td>Bresslers</td>
<td>Jack in the Box</td>
<td>Brown’s Chicken</td>
</tr>
<tr>
<td>Kentucky Fried Chicken</td>
<td>Burger King</td>
<td>Wendy’s</td>
</tr>
<tr>
<td>Burger Chef</td>
<td>In and Out Burgers</td>
<td>Shakeys</td>
</tr>
<tr>
<td>Carl’s Jr.</td>
<td>Mr. Submarine</td>
<td>Shoney’s</td>
</tr>
<tr>
<td>Carrow’s</td>
<td>Rally’s</td>
<td>Del Taco</td>
</tr>
<tr>
<td>Taco John’s</td>
<td>Taco Bell</td>
<td>Taco Time</td>
</tr>
</tbody>
</table>

Provided that any food service establishment which offers as the primary method of service for all meal times, food and drink orders taken by and served by a waiter or waitress at the customer’s table is excluded from the term “restaurant.”

Notwithstanding the foregoing, any food service establishment not listed above operating in-line only within a multi-tenant building without a drive-through window is also excluded from the term “restaurant”.

However, requested restrictions may not obtain the desired effect in the case of after-acquired property. See Edmond’s of Fresno v. MacDonald Group Ltd., 217 Cal. Rptr. 375 (Cal. Ct. App. 1985).
VIII. “GREEN” BUILDING REQUIREMENTS

In 2000 the United States Green Building Council launched a building certification system which provides nationally accepted benchmarks for construction and design of buildings that incorporate certain renewable energy, energy conservation and environmentally friendly features. The acronym for the certification system is LEED (Leadership in Energy and Environmental Design).

Seattle, King County and other governmental subdivisions have adopted an array of programs and incentives to encourage design, construction and use of buildings which comply with the LEED certification requirements. Economic incentives and tax benefits are available. See www.seattle.gov/dpd/greenbuilding.

Increasingly we are seeing restrictive covenants in various commercial developments based upon LEED certification requirements.

Example: Commercial/Retail Development

All commercial and retail spaces will be designed and constructed to meet LEED certification. This covenant shall expire upon completion of construction of the Project in a manner consistent with the requirements of this agreement.

Example: Residential Development

All housing units in the development must meet either LEED certification or Built Green certification at the highest level determined to be economically feasible by buyer in the exercise of its business judgment.

Attorneys for developers, governmental agencies and landlords should be sensitive to the benefits and potential extent of LEED certification related use restrictions.
IX. CONCLUSION

Restrictive covenants are important. They materially affect the life of shopping centers or other multi-use developments. When not carefully considered in drafting, valuable interests of one or more parties may not be protected or unnecessarily and expensively left for determination by judicial strangers.

Accordingly, whether drafting or negotiating a lease or other agreement for a development, the key for the lawyer is to be thoughtful, specific and clear in considering restrictive use provisions so as to ensure protection of your client’s business interests.