SHOPPING CENTER BUSINESS
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Risky Business

Restrictive covenants in today's retail marketplace.

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Faced with the enormous pressure of filling empty spaces in strip centers, regional malls and other retail outlets, landlords may feel an incentive to ambitiously revisit the restrictive covenants and exclusives contained in their existing leases.

This self-motivated incentive combined with changes in the retail marketplace could place landlords in litigation jeopardy. For example, many retail leases have provisions prohibiting so-called "schlock" or other undesirable uses in shopping centers.

But liquidators and retailers who concentrate in sale of oversupply, damaged, or off-season items have been popular and accepted in the marketplace in the past decade. In the retail leasing marketplace over the last two years, certain of these retailers have grown sufficiently both in sales volume and number of locations.

In a shopping center facing multiple vacancies, many tenants are happy to see almost any new tenant join them in an otherwise dead center. A landlord may not face initial opposition to the introduction of the oversupply retail tenant. Yet, many leases contain provisions which arguably could be interpreted to exclude such uses. Although parties who sleep on their rights often are not well-received by the courts, non-waiver provisions in leases do not eliminate risks of claims once the economy recovers.

Retail landlords need to think twice before taking such steps to attract potential tenants who violate schlock or other restrictions. The risk of costly and protracted litigation brought by disgruntled tenants may far outweigh any short-term benefits achieved.

Restrictive covenants in shopping center leases have long been recognized as effective tools for managing tenant mix and protecting tenants' interests. While outside the scope of this article, these restrictions have been respected by the bankruptcy code and in bankruptcy litigation solely to the extent necessary to preserve tenant mix.

In many states, restrictive covenants are per se enforceable. Accordingly, tenants are typically quick to seek court intervention when they believe that the rights in their leases are being threatened. An oversupply retailer could be vulnerable to claims that it has violated an exclusive as well as "schlock" prohibitions. Oversupply retailers control their inventory with less precision than many other retailers and their general offerings may be more prone to trip exclusives than other retailers. It is not uncommon for tenants protected by such restrictions to seek both injunctive relief and damages for such violations.

While the courts have ruled some lease restrictions unenforceable, there is ample case history where tenants have prevailed.

A Florida court in 2007 upheld Winn-Dixie's leasehold right to be the exclusive grocery seller in a shopping center outside of Pompano Beach. Winn-Dixie brought suit against its landlord to enjoin another tenant, Dollar Store, from selling groceries. Dollar Store dedicated only about 500 square feet of retail space to grocery sales. Nevertheless, the court found that Winn-Dixie's supermarket restriction operated as a "covenant running with the land" and was therefore enforceable.

In 2003, a greeting card store in a strip mall located outside Worcester, Massachusetts, brought suit against its landlord for breach of its lease when the landlord sought to rent adjacent space to a general goods retailer that also sold greeting cards, albeit as a minor component of its business. The court entered a permanent injunction against the landlord restraining the new tenant from selling greeting cards.

Tenants, however, do not always prevail. The Missouri Appeals Court in 2007 rendered a decision that indicated a preference that disputes over the validity of a restrictive covenant be resolved in favor of the free use of property. Courts will look first to the language of the document, ruling against tenants when a restriction is found to be either unreasonable or without clear parameters. In 2009, for example, the Connecticut Superior Court held that a restrictive covenant was not valid because it was unlimited in duration and had no clear beneficiaries.

The language of the document is paramount to its interpretation. The original intent of the parties entering into the restriction may also be a factor. If the original intent is no longer the driving force behind its enforcement, the court may rule that the restriction has lapsed. In one such case, the Supreme Court of Indiana in 2005 refused to uphold

the validity of a restrictive covenant where the original beneficiary of the restriction had subsequently vacated the benefited retail space.

Courts typically consider material changes in the neighborhood or retail landscape since the covenant was negotiated. Recently, the New Hampshire Supreme Court declined to enforce a deed restriction that prohibited the use of a parcel as a restaurant. The Court found that the area had undergone sufficient commercial development since the restriction was executed so as to render the restriction obsolete.

Whether a court will enforce a restrictive covenant contained in a retail lease turns largely on individual circumstances (the language of the provision, the circumstances at the time of its execution, the subsequent history of each of the parties use and, the particular shopping center and its environs, for example). It can be risky for landlords to be overly aggressive (i.e. self interested) in their interpretation of such lease obligations.

In the current hard times, tenants may be quick to protect market share and seek to enforce restrictions even more zealously than usual. In the current economic climate, landlords would be wise take the time to carefully review the enforceability of existing restrictive covenants before wooing tenants who could ultimately land them in court.

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