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### Battle Over Leasing Covenants in Lieu of Exclusives

Leasing covenants are a compromise of the landlord's and tenant's desires

By Kenneth M. Morgan

**E**xclusive use clauses in leases grant tenants exclusive rights to offer a product, or merchandise or provide a service within a defined area. The typical exclusive clause is accompanied by the landlord's agreement not to grant the exclusive use to any other tenant or occupant of the center, not to permit any other tenant or occupant of the center to engage in the exclusive use, and to make the exclusive binding on all future tenants of the center. (M. Virginia Perry, Remarks at International Council of Shopping Centers United States Shopping Center Law Conference (January 10, 2008) (outline of remarks)). For example, the tenant may be the only tenant allowed to sell premium brand coffee as its primary business. The protected area may be a portion of a shopping center or may be more broadly defined

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to encompass lands within a protected radius.

Exclusives were historically provided on a selective basis primarily to anchor tenants such as supermarkets and department stores occupying a significant portion of the center's rentable square footage. These retailers received "preferential treatment" as compared to other tenants because they attracted customers to the center for the benefit of the entire center. Their ability to draw in customers gave such tenants significant bargaining power during lease negotiations.

Over time exclusives have become more prevalent on a national and regional basis and are no longer confined to anchors and national retailers. This is due to a number of factors, including the changing nature of retail and service industries, proliferation of national franchises, and changes in consumer spending habits. Exclusives are now regarded as a requirement by nearly all national retailers and are often considered deal breakers. Most tenants now ask for exclusives before leasing space in a center, even small retailers taking only 1,000 to 2,000 square feet of space. Regional franchises, with real estate expertise at the franchisor level, have also been successful in extracting exclusives from landlords.

Since landlords understand that tenants are willing to forego a leasing opportunity rent space from a competing center, they often concede to demands and provide the desired exclusive rights, although the scope of the clause is often the subject of zealous negotiations. During such negotiations, the tenant will argue that it does not want to invest significant dollars towards fit out, marketing, administrative and other costs if it will face significant competition and will demand protection of its core products and services. While exclusives benefit a single tenant, they may do so at the expense of the entire center, and may reduce the market for prospective replacement tenants.

From the landlord's perspective, too many exclusives have been awarded recently, limiting landlord's leasing flexibility. Landlords fight to define the scope of the exclusive as narrowly as possible, while demanding tenants require broad, open-ended protection to enhance future profitability. However, it is very difficult for the landlord to assess the tenant's true core business that deserves protection in a long-term lease because retailing is subject to constant change and retailers products and services increasingly overlap. This is particularly true in the food service

industry, where hamburger retailers sell salads and premium coffee and premium coffee retailers offer breakfast sandwiches and allow customers to download music.

Exclusive use provisions are often among the most time consuming and strenuously debated lease terms. Landlords have the burden of identifying exclusives granted in future leases, obtaining a covenant from future tenants not to violate any previously granted exclusives and policing and enforcing the exclusives if violated. Keeping track of the various rights and prohibitions can be significant administrative task.

Exclusives can be waived by the protected tenant, thereby providing the tenant the power to decide who it wants in the center. Waiving tenants may also be able to extract concessions from their landlords. Landlords have to make business decisions with respect to when to approach tenants for waivers. If a prospective new tenant is not going to rent a significant amount of square footage and/or is not expected to be a phenomenal draw to the center, the landlord may elect not to approach the protected tenant for a waiver, thereby bypassing an opportunity that could benefit the center.

Instead, the landlord may wait for the right time and the appropriate new tenant before approaching the protected tenant for a waiver. These restrictions hinder the landlord's ability to determine an appropriate tenant mix and make the process of filling a center something of a jigsaw puzzle.

Landlords have attempted to be more selective about granting exclusives and in some cases would prefer not to give them at all. In North Carolina, Alabama and other parts of the country, landlords are attempting to utilize leasing covenants in lieu of exclusives in an effort to avoid the obligations associated with exclusives. (R. Robinson Plowden, *Agree to Landlord Leasing Covenant to Keep Center Free of Exclusives*, COMMERCIAL LEASE LAW INSIDER (The International Council of Shopping Ctrs., New York, N.Y.)

This approach is sometimes known as the "give none, get none" approach. Leasing covenants are intended to give a retailer the protection for its use while removing the administrative burden from the landlord in enforcing exclusives. (Camilla Titterington, *Leasing Covenant Loopholes*, Commercial Leasing: Law & Strategy (ALM, New York, N.Y.)

"A landlord leasing covenant provides retailers with a personal covenant from the landlord stating that the landlord will not willingly and intentionally lease space in the shopping center . . . to another tenant engaging in the protected use or selling the protected products." (James B. Jordan & Roy P. Ruda, *Leasing Covenants: A Viable Alternative to Exclusives -- Part 2*, RETAIL LAW STRATEGIST (The International Council of Shopping Ctrs., New York, N.Y.)). The landlord typically covenants that he will not enter into a lease or occupancy agreement with a direct competitor so long as the tenant remains open for business and is not in default under the lease beyond any applicable cure period. By giving a leasing covenant, the landlord takes on the risk of determining which retailers are direct competitors to the tenant. (Perry supra at note 1.)

The landlord does not grant an exclusive right or guarantee the absence of competition. The covenant is not as comprehensive as an exclusive (Plowden supra at note 2). The landlord is bound by the covenant but other tenants are not and these other tenants may change their use or assign or sublease their space to a competitor of an existing tenant.

Leasing covenants are a compromise between a landlord's desire not to grant any exclusives and a tenant's desire to be protected from competition, and offer flexibility to both parties. While covenants provide the tenant with less protection than an exclusive, they also provide the tenant with the flexibility to change its merchandising mix or service without fear of running afoul of other tenants' exclusives.

Covenants may allow the tenant to

more freely assign or sublease its space if it decides to shut down an unproductive location prior to the end of the lease term. Landlords can have a number of retailers, whose incidental products and services may overlap, thereby improving the landlord's ability to market the center and lease the center to capacity.

A tenant willing to buy into the leasing covenant concept will often demand springing exclusive rights in the event the landlord grants exclusives to other tenants contrary to its representation and covenant. The springing exclusive comforts the early signing tenant that the landlord will not subsequently grant exclusives in order to lease out the balance of the center by creating a disincentive for landlord to violate its covenant.

Leasing covenants have only been used for the past few years. They have not yet caught on in popularity on a national or regional level, and remain the exception rather than the rule. Leasing covenants are unlikely to replace exclusives and become popular in New Jersey in the near future for a number of reasons.

To begin with, landlords will probably encounter significant reluctance from tenants to the leasing covenant concept because it newer and less known than exclusives. There is very little case law and therefore greater uncertainty as to how they will be treated if litigated as compared to exclusives, which tenants know are generally enforced by the New Jersey courts.

Tenants and their leasing brokers and attorneys will need to be opened minded in order to accept leasing covenants, and will need a strong incentive to do so, such as a phenomenal new location or below market rents. Landlords will also need to overcome the trend over the past decades of the spread of exclusives, which have become ingrained in retail leasing and demanded by retailers.

Leasing covenants have the best chance of taking hold in newly con-

structed centers that are not subject to existing tenants with pre-existing exclusives. Because New Jersey is so highly developed and land use regulations have become increasingly stringent, the untapped development potential for new centers is lower in New Jersey than it is in most other states. A good percentage of center development in New Jersey will likely involve redevelopment of existing centers rather than new construction, and in such redeveloped centers existing tenants will likely have already obtained exclusives which they will not willingly relinquish. Anchors will almost never agree to be subject to the "give none, get none" philosophy and most big boxes will object, at least initially, and agree only if the leasing

covenant is subject to a host of exceptions.

The resolution of the battles between New Jersey landlords and tenants over leasing covenants in lieu of exclusives will likely depend on the parties' respective bargaining position, which has recently swung in favor of tenants. "The International Council of Shopping Centers projects 2008 store closings could reach 5,770 stores in 2008, the largest number of closings since 2004. Retailers as a whole reported their worst January same-store sales in almost four decades. (Mae Anderson, "Two Retailers File For Bankruptcy," *The Philadelphia Inquirer*, February 21, 2008, at C3.)

Lower demand from tenants for space in centers will certainly play

into negotiations and may force landlords into giving concessions. Given the weakening leasing climate and projected increases in vacancy rates, it is likely that tenants will successfully reject the efforts of the landlords to establish centers with leasing covenants in lieu of exclusives in the near term.

For now, New Jersey landlords will hope that the economic climate improves and leasing covenants become more popular throughout the rest of the country so that retailers will be more receptive to the concept when the market eventually swings back in favor of landlords. Landlords will pick and choose their battles until the time is right, and will then bring this issue to the forefront. ■