

Exclusives – Clearing Up the Ambiguity

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If you have been involved in a retail center, you likely have analyzed, negotiated, drafted or litigated an exclusive. Exclusives, a category of restrictive covenants, prohibit certain uses for the benefit of a specific party. Unfortunately, exclusives are often ambiguous, causing unintended consequences and confusion. They can be difficult to draft and interpret and are not always easy to find. In retail centers undergoing change, they can stop change in its tracks.

If carefully negotiated and drafted, exclusives can be integral to the success of a retail center by helping to provide the correct retail mix. Exclusives should attempt to balance the interests of landlord and tenant. An exclusive may be necessary to protect a tenant's business and provide incentive for a tenant to locate at a retail center. Conversely, an exclusive should allow landlords the flexibility to create a retail mix that results in a competitive edge for the retail center. Clear exclusives can both protect tenants and allow landlords flexibility.

Underlying Law

When clear and unambiguous, Minnesota courts will generally enforce exclusives as intended by the parties who created them. However, courts are inclined to narrowly construe exclusives based on public policy against restraints on trade with all doubt resolved against enforcement. As a result, exclusives will likely be narrowly interpreted if ambiguous. Ambiguity should have the effect of limiting the protection provided by the exclusive. Often, the underlying law will work against the tenant wanting the protection of the exclusive.

Narrowly Tailor and Clearly Define

The first and one of the most important steps is to narrowly tailor the exclusive and define terms with as little ambiguity as possible. Review each word used in the exclusive to determine if it needs further definition. Define even somewhat ambiguous words and phrases so that anyone can understand what is meant. Don't rely on implied conduct and standards of the trade. When in doubt define.

Try to give exclusive sales clauses that allow the exclusive right to sell certain products or services rather than exclusive use clauses that allow the exclusive right for a certain type of store or use. An example is an exclusive for the sale of food (exclusive sales clause) versus grocery store (exclusive use clause). Exclusive sales clauses are more precise if properly defined. Exclusive use clauses are more prone to interpretive

problems. Types of stores are not easily defined and the exclusive becomes ambiguous. With so many stores selling such a variety of products, stores can be classified as many different types of stores or having many different uses. For instance, a bagel shop selling coffee could be defined as a coffee shop (in addition to a bagel shop) for purposes of a coffee shop exclusive.

Specifically list the products or services protected by the exclusive. Focus on limiting the exclusive to only include the products or services that are a tenant's primary business. Narrowly craft language that protects the primary business from competition but does not expand to secondary or complementary products or services. Never include incidental or related uses in the exclusive. Usually, the exclusive should be narrower than the permitted use of a tenant.

If a type of store or use cannot be avoided for an exclusive, try to further define the type of store or use as much as possible. Consider qualifying the type of store or use as being tenant's primary or principal business. Then further define primary or principal business as the use of a certain percent of sales floor area or a certain percent of revenue.

If possible, never adopt a tenant's standard exclusive provision without a thorough review. Although anchor and strong tenants may insist on their standard exclusive provision, it may be antiquated and broader than the current reality. For instance, if you are dealing with a grocery store exclusive that prohibits the sale of groceries, there are two elements being protected. Groceries are defined as "articles of food and other goods sold by a grocer." Since a grocer is commonly defined as a dealer in staple food stuffs and many household supplies, this means that both food and non-food items qualify as groceries. The non-food items prohibited from being sold could be virtually limitless (i.e. soap, paper towels and aspirin). Many grocers realize that such a broad protection is not beneficial to their business. In these situations, a well reasoned revision to a tenant's standard exclusive provision may be acceptable.

Exceptions to the Exclusives

Exceptions to the exclusive are important. Exceptions also need to be clearly drafted so that they are proper in scope. Overbroad and unclear exceptions can cause an exception to swallow the exclusive and make it moot. Some exceptions to consider are as follows:

Incidental Sales Exception

An incidental sales exception allows for the incidental sales of protected products that would otherwise be prohibited by an exclusive. Without an incidental sales exception, an exclusive will often extend farther than anticipated. For the incidental sales of protected products, try to define the allowed incidental sales area by square feet rather than a percent of sales. A square foot standard is easier to review for compliance. Percent of sales is difficult to review for compliance because other tenants subject to the exclusive would need to report sales to landlord by the category of the protected product. Such categories are rarely available to third parties and may not even be tracked by the tenant

subject to the exclusive.

Using square feet to calculate the allowed incidental sales area of protected products requires further definition. Make sure to include if the allowed incidental sales area is for all protected products in the aggregate or for each protected product. Also, make sure to clearly state how to measure the allowed incidental sales area for the protected products. While measuring the square feet involved seems straight forward, landlord and tenant may have vastly different methods of measuring the allowed square footage. A suggestion is to measure using fixtures/gondola area.

Existing Tenant Exception

Another exception to consider is an existing tenant exception. Without such an exception, conflicts will likely arise between the exclusive being granted and the permitted use clauses of existing tenants. Ideally, to avoid any issues with existing tenants, an exception to an exclusive should be made for all existing tenants operating as permitted under their lease. However, this is a large exception to an exclusive because broad permitted uses under existing leases that are freely assignable may lead to changes in use that pose direct competition threats to a tenant. One way to slightly limit this exception is by adding language that if a landlord's consent is required to for a use change, then landlord shall not consent to a change that will violate the exclusive.

To clarify the scope of the exception for existing tenants, consider limiting the exception to a list of permitted uses of the existing tenants attached to the lease. A benefit of this approach is that the tenant can review the permitted uses and analyze the potential for competition from existing tenants. A drawback is that it can be administratively burdensome for the landlord. Also, since the language of the permitted use attached should be exactly as set forth in the lease of the existing tenant from which it came, definitions can poses challenges that make the permitted use unclear.

Major Tenant Exception

An exception for major tenants occupying over a certain square footage of space at the retail center should also be considered. The definition of "major tenant" depends on the size of the retail center and the realistic possibility of the size retailer that may lease space at the retail center. Generally, major tenants will not be willing to modify their operations for a particular retail center and will be reluctant to consider a retail center that requires modification. This exception can be especially important for a retail center that is evolving and changing its focus.

One concern of a tenant is that both the major tenant exception and the existing tenant exception expose the tenant to possible store-in-store competition. A major tenant whether existing or in the future may be able to operate with smaller store-in-store concepts that directly compete with a tenant. For example, all of a sudden a coffee shop can exist within the large discount store that competes with another coffee shop within the retail center. A tenant may want to attempt to limit these exceptions to minimize

store-in-store competition.

Small Tenant Exception

For tenants leasing larger areas who want an exclusive, consider carving out a small tenant exception. This could allow smaller in-line tenants to sell competing products that do not pose significant competition to the larger tenant.

Specific Tenant Exception

Always carefully analyze both existing and potential future permitted uses that may be problematic with an exclusive. If a potential future permitted use is contemplated that may conflict with an exclusive, then consider adding a specific exception to the exclusive for the potential future permitted use. For instance, an exclusive for massage services may need to carve out a potential future permitted use of massages by a chiropractor or medical clinic. Also, if the permitted use of an existing tenant may conflict with an exclusive, then consider adding a specific exception to the exclusive for the permitted use of the existing tenant. While adding a specific tenant exception may be duplicative, the specificity should eliminate any potential conflict or inconsistency between the permitted use and an exclusive. In addition, pre-approval of a potential future permitted use at lease execution is often easier to get from tenants interested in the retail center than a subsequent lease amendment allowing the permitted use.

Understand Geographic Scope

Make sure that the geographic scope of the exclusive is clearly defined in the lease by including a legal description and depiction of the retail center subject to the exclusive if possible. A depiction of the retail center showing the lots and outlots and their legal descriptions should be reviewed to understand the extent of the exclusive. A reference to the exclusive affecting the retail center without more is often ambiguous. The exclusive may extend to the entire retail center, only a portion of the retail center, or even outside the retail center within a certain radius. An ambiguous geographic scope could inadvertently extend the exclusive beyond land owned by the landlord. Conversely, it may not cover the entire area anticipated by tenant. A tenant should consider extending the exclusive to adjacent land owned by landlord or parties related to landlord and including a clause that extends the exclusive to after acquired land by the landlord or parties related to landlord. If such clauses are included, make sure to clearly define parties related to landlord.

Duration

Often by default, the duration of the exclusive is the term of the lease. However, the duration of the exclusive could be for a shorter period allowing the tenant to get an initial competitive advantage and then terminating to allow landlord flexibility. It could also be automatically terminated earlier if the tenant stops selling the protected product or service, stops operating its business, or as a result of default. The timing before

automatic termination in the event that tenant stops selling the protected product or service or stops operating its business should be long enough to allow for remodeling, casualty, events of force majeure, and other temporary closures of the business. Without termination in such situations, the tenant could have the ability to pay rent, not operate, move to a different location, and keep its competitors out of its former location with no incentive for the tenant to continue operations. The timing before automatic termination in the event of a default should include a cure period. The parties can also consider reinstatement of the exclusive in the event of a resumption of sales. With any reinstatement of the exclusive, permitted uses of intervening tenants would need to be considered.

Remedies

Remedies for violation of an exclusive should be considered to clarify damages and enforcement. If there is no mention of remedies in the exclusive, then all remedies at law or in equity may be available unless limited elsewhere in the lease. This includes the possibility of injunctive relief and actual damages for violation of an exclusive. Both landlords and tenants may have concerns with actual damages. Landlords may be concerned that actual damages could include lost profits and other consequential damages. Tenants may be concerned that actual damages would likely be difficult or even impossible to prove. Damages may be speculative at best leaving an injunction as a likely remedy.

Termination, buy-outs and liquidated damages are alternative remedies to consider in lieu of actual damages for violation of the exclusive. One version of liquidated damages is rent abatement. Make sure to clarify the amount of rent abatement and whether it applies to minimum rent and/or additional rent. Rent abatement could occur during a certain time period after which tenant has the option to either terminate the lease for a limited time period or resume paying full rent. Liquidated damages need to be reasonable to avoid being classified as an unenforceable penalty.

Landlords should have a reasonable time period to determine if a violation has occurred and then to cure the violation of the exclusive before remedies are imposed. The time period granted the landlord may be significantly different in the case of an intentional violation by landlord compared to an unintentional violation. Unintentional violations include inadvertent violation, questionable violation or a violation by a rogue tenant. Sometimes there is a bona fide dispute if a violation has occurred. Other times the parties have to deal with a rogue tenant even though landlord has done everything right by properly restricting the use of the rogue tenant to comply with the exclusive.

To allow for these unintentional violations of the exclusive, the time period before remedies are imposed should be long enough to allow enforcement or settlement of the dispute concerning the exclusive. Remedies could be delayed as long as landlord is diligently pursuing cure or for a limited cure period. A limited cure period between three months to two years may be reasonable depending on the circumstances of the violation and the severity of the remedy.

Another item to possibly consider is which party is responsible for enforcement of the exclusive. Tenants will want, and landlords often agree, that landlords, at their cost, are responsible for enforcement of the exclusive. However, responsibility for the enforcement of the exclusive may be allocated to tenants, at their cost, if the exclusive is drafted to allow the tenant to proceed.

Analysis and Administration

Before entering into a new lease, landlords should perform certain due diligence to avoid conflicts between the exclusives and the permitted uses of the new and existing tenants at a retail center. Landlords should conduct a separate analysis for the exclusive and permitted use in the new lease. Unfortunately, the analysis of exclusives and permitted uses are often lumped together and confused as a single concept. The distinction in the analysis of the exclusive and permitted use in a new lease is often lost because of the interrelationship between the concepts.

To properly analyze the exclusive in a new lease, landlords should review the permitted uses in the leases of all existing tenants for conflict with the exclusive in the new lease.

To properly analyze the permitted use in a new lease, landlords should perform a separate and different review of the exclusives in the leases of all existing tenants for conflict with the permitted use in the new lease. Also, don't forget to review prohibited uses and exclusives contained in reciprocal easements and operating agreements and other recorded and unrecorded documents. The exclusives in these documents may be different than what is contained in a lease.

To minimize the potential for creating a conflict between the exclusives and permitted uses of the new and existing tenants in a retail center, all existing exclusives and permitted uses should be tracked. I would suggest creating separate lists for all exclusives and permitted uses so that a list for each is created. I would then suggest listing each exclusive and permitted use in two separate ways. The first listing being a summary description. The second listing being the entire and exact language of the same exclusive or permitted use. The summary description can be used for practical and quick review and possibly for a letter of intent. The entire and exact language will need to be reviewed as part of the drafting of a new lease to make sure it complies with the exclusives and permitted uses of existing tenants. This review is more time consuming and difficult than one might think and can be a significant administrative hurdle for landlord. As a result, consider trying to keep the exclusive and permitted use language in the letter of intent more general. Specifics can be worked on during lease drafting. If a detailed exclusive or permitted use is insisted on by the tenant in the letter of intent, then an in-depth analysis of the exclusives and permitted uses of existing tenants should be conducted before executing the letter of intent.

Conclusion

Clear exclusives avoid conflict and benefit both landlords and tenants. Careful drafting and analysis of an exclusive is critical. Exclusives need to be narrowly tailored and include appropriate exceptions. Concepts that need to be addressed to create clear exclusives include geographic scope, duration and remedies. Before entering into a new lease, landlords should create and analyze separate lists of existing exclusives and permitted uses to avoid conflicts between the exclusives and permitted uses of the new and existing tenants at a retail center. As a final note, while this article discusses concepts to create clear exclusives in the landlord and tenant context, these concepts will work when drafting an exclusive in any context.