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BARRISTERS & SOLICITORS

## **"Use Restrictions in Commercial Leases"**

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## **USE RESTRICTION PROVISIONS IN COMMERCIAL LEASES**

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## INTRODUCTION

A system of inter-related use restrictions has evolved within shopping centre store leases to control uses. This is done to balance the need for businesses to grow and change, against the need to ensure that a community of interest within the shopping centre enables the maximum number of businesses to flourish within a healthy competitive environment.

This system of use-restrictions needs to be examined as a whole. Otherwise litigation is probable. The several key areas within the lease document which comprise this use restriction system are as follows:

(a) **Use and Trade Name Restrictions Applicable to a Particular Leased Space Occupied by the Tenant**

These limit the type of business that is to be operated within a particular store and the trade name or style under which the tenant is to operate.

(b) **Continuous Operating Covenant**

This is the covenant under which the tenant agrees to actively carry on a particular type of business in the store. Normally as an adjunct there will be a minimum number of hours specified or some obligation to adhere to prescribed hours for the shopping centre.

(c) **The Exclusive Use Restriction**

An exclusive use restriction is one under which a tenant obtains the right to prohibit certain types of competition within a shopping centre. These provisions are not normally part of a standard lease form but are instead negotiated as an amendment to the form.

(d) **The Radius Restriction**

The radius restriction limits the ability of the tenant to compete with his own business within the shopping centre and, more significantly, limits general competition against the shopping centre by restricting the area within which the tenant can lease space in shopping centres and other locations that are in competition with the shopping centre.

(e) **The Assignment, Subletting and Transfer Restriction Clauses**

This is the provision which allows the landlord to restrict the ability of the tenant to sell its business to a third party.

To minimize the risk that is inherent in dealing with any one of these types of restriction in isolation of the others and to assist in identifying major problem areas in the drafting and negotiating of each of these areas, a check-list is set out below with notes and commentary.

## CHECKLIST AND CASELAW CITATIONS

### (1) *The Use Clause and Trade Name Restriction*

If you are looking after a landlord's concerns, as a general rule it is best to be as specific and detailed as possible. It is best if these restrictions are structured as follows:

#### (a) General Category of Store

Describe the type of store or business to be operated (i.e. a sporting goods store, an apparel store, a licensed restaurant, a fast-food store such as a hamburger outlet, a pizza outlet, etc.).

#### (b) Identify The Theme and Trade Name

Identify the theme for the store (i.e.) a women's high fashion clothing store, a men's clothing store, a children apparel store, a family economy oriented apparel store, and specify the name under which the store will operate. It is useful to identify an existing store or group of stores that are already in operation by the tenant under the trade name and to state that this store will be similar to or typical of the other store or stores.

#### (c) Illustrate the Categories of Merchandise

Describe a number of categories of merchandise which are intended to be sold in order to illustrate the type and theme. This can be done on an inclusive basis (i.e. including but not limited to, or including by way of example but not by limitation).

#### (d) Preserve a Balance of Merchandise

Give careful consideration to the extent to which a balance or mixture of categories of merchandise within the general theme must be preserved. Otherwise, the tenant by over emphasising one particular category of merchandise or changing its emphasis from one category to another, can change the general type of store and theme in which it is to operate. For example, if a sporting goods store use provision were worded as follows:

"The tenant will sell only those items typically sold in sporting goods stores".

the tenant could begin emphasising sports apparel as opposed to sports equipment or could change from a store that primarily sells bicycles and accessories to a store selling primarily golf equipment or skis. It should be apparent therefore that it is necessary to describe a theme for the store i.e. a golf shop or a cycle shop and to require the tenant to sell a selection of merchandise that is consistent with that theme."

(e) **Identify Ancillary Merchandise**

If items are to be sold on an ancillary basis, that should be indicated and, again a general description of the types of merchandise that can be sold only on an ancillary basis should be identified. Ancillary categories should be restricted in terms of floor area, shelf space, perhaps proportion of advertising dollars, and the permitted proportion of sales of ancillary items from the store.

(f) **Identify Prohibited Categories**

It is also important to identify certain categories of merchandise which might otherwise have been permitted in the general theme and description of merchandise listed above but which are restricted under the exclusive covenants that may have been granted to other tenants within the shopping centre. A landlord must also give consideration to the types of other stores that are planned to be leased by it and the possibility of the need to grant exclusives to other tenants in order to attract them to the shopping centre. If there are exclusives granted to other tenants already within the shopping centre, it would be useful to provide copies of those to the tenant in advance and if the landlord intends to grant specific exclusives, it would be useful to require the tenant to agree in advance to abide by them.

(g) **Consider Anchor Store Restrictions**

There will normally be included in the leases of major tenant within a shopping centre such as department store or junior department stores, a group of prohibited use within a shopping centre that have more to do with the quality of the merchandising environment than the need to protect the anchor's store against competition. These are, for example, prohibitions against the sale of pornography, the operation of a betting facility, dance halls, massage parlours, etc. Generally these types of restrictions are covered in the standard language of the lease document but, the standard language must be examined against the specific provisions that may have been negotiated by anchor store tenants.

From the tenant's perspective, it is important to keep the following considerations in mind:

(h) **Preserve Flexibility**

The tenant must be able to allow its business to evolve in order to maintain competitiveness. If it restricts its type of store, theme, and permitted categories of merchandise unduly it will be left behind as marketing and merchandising environments change. The tenant's best position is to be general, to avoid specificity and not to agree to limit its ability to change.

(i) **Consider the Need to be Able to Sell Your Business**

It is critical for the tenant to keep in mind the possibility of a sale of its business. If it has not built into the document the right to change the tenant trade name, or to change use when it assigns or sublet, it may find itself locked into operating long term within an environment which is not suited to its business. The more restrictions specified and included within the use clause, the more difficult it is, for a tenant to assign or sublet or transfer its business. Each restriction on use, limits the market to which it can sell. For example, if a tenant agreed that it would operate throughout a term only a typical "xyz" type store, similar to the other "xyz" stores operated by the tenant within the Metropolitan Toronto area, its ability to assign the lease would be greatly restricted.

**ADDITIONAL CAUTIONARY NOTES FOR LANDLORDS**

(j) **Beware of Inadvertently Consenting to a Change in Use**

From a landlord's perspective, if a tenant simply agrees to carry on business within a store in a manner similar to the way in which the tenant carries on business in its other stores within a geographical area, the landlord may encounter unexpected, unhappy consequences. The landlord needs to keep in mind that on a transfer of the lease by the tenant to a third party, it may find that the new tenant operates a very different type of business, which is incompatible within the shopping centre. However, because the obligation is only for the tenant to operate in the same way as in its other stores, it obtains the right, in effect, to change the business on the assignment or subletting. Also if a tenant changes its style of operating in its other stores the tenant indirectly obtains the right to change its use in the store it leases from the landlord.

(k) **Avoid Implied Exclusive**

Case law in British Columbia, has opened the door to the possibility of a court implying in favour of the tenant, an exclusive use provision, when the tenant agrees with the landlord to carry on only a particular type of business within the premises and to abide by the use restrictions granted to other tenants within the shopping centre. From a drafting perspective it would be useful to avoid any implication that an exclusive covenant is intended by stating expressly within the use clause that no exclusive or covenant against competition within the shopping centre is to be implied or inferred from the use restrictions.

Similarly, to avoid an implication that the landlord's covenant to operate the shopping centre in a first class manner or in a reputable manner, would be construed so as to force the landlord to develop a merchandising plan for the shopping centre that avoids undue competition to the tenant, express language to that effect should be included in the lease.

There is an increasing tendency among courts to apply doctrines of good faith in contracts.

For example, if a landlord's representative has made promises to a tenant concerning the landlord's intention to protect the tenant against undue competition, the absence of an express exclusive in the lease will not excuse the landlord from liability if the tenant relied on those promises.

In conjunction with the comments noted above concerning implied obligations, the following cases and article should be noted:

*Gateway Realty Ltd. v. Arton Holding Ltd.* (1991), 106 N.S.R. (2d) 180 (S.C.); aff'd (1992), 112 N.S.R. (2d) 180 C.A. dealing with the implied obligation to deal in good faith; and

*M.D.S. Health Group Ltd. v. King Street Medical Arts Centre Ltd.* (1994), 12 B.L.R. (2d) 209 (Ont. Gen. Div)

*First Avenue Market Place (1986) Inc. v. Nick Manthos and Sam Marky*, 43 R.P.R. (2d) 283

*Deminchuk Enterprises Ltd. v. Deer Valley Shopping Centre*, [1993] A.J. No. 547 (Q.B.) (QL)

Good Faith in Contractual Performance: Recent Developments by Shannon K. O'Byrne. *The Canadian Bar Review* vol. 74 March 1995.



**(2) Exclusive Use Restrictions**

The consequence of breaching an exclusive (whether implied or expressed) can be severe. In one case the court allowed a tenant to terminate its lease and sue for damages when the Landlord is permitted the sale of food in a couple of vending machines in a cafeteria area in contravention of the exclusive on food sales within a building. See *Prince Business Inc. vs. Vancouver Trade Mart Inc.* [1993] B.C.J. No. 1692 (S.C.) (QL); additional reasons at [1993] B.C.J. No. 1693 (S.C.) (QC), affirmed [1994] B.C.J. No. 2647 (C.A.) (QL)

Exclusives are fruitful sources of litigation. The following suggestions for Landlords should minimize exposure and reduce the possibility of unexpected unwanted situations:

**(a) Exclude existing tenants**

If the landlord grants an exclusive to a new tenant, it is likely to discover that other existing tenants within the shopping centre have the right within their use clauses (especially if they are not drafted carefully) to infringe the restriction granted to the new tenant.

**(b) Exempt existing tenants that do not have an existing option to renew but may wish to renew their leases**

The granting of a new lease to an existing tenant could infringe the restriction on the landlord against leasing space, within the shopping centre to competing uses.

**(c) Restrict the exclusive so that it does not apply to replacements of existing uses by new tenants**

If, for example, a shoe store lease ended, the landlord may choose to lease that particular space to another shoe store operator. The landlord should be able to preserve that particular component within its merchandise mix without offending the exclusive granted to the new tenant.

**(d) Restrict the exclusive to the tenant's primary use**

Avoid granting an exclusive in favour of a tenant that would allow it to prohibit other tenants from selling the same merchandise as the tenant or from selling merchandise which the tenant sells only as an ancillary part of its business. The theme or basic concept of the tenant's business can be protected, but categories of merchandise that are merely incidental, related to, or subsidiary to that main, principal use should not be restricted. For example, if a tenant's permitted use were that of a sporting goods store and an exclusive were granted against competition by other tenants within the shopping centre that sell the same types of merchandise as the tenant, the tenant would control over a very wide ambit of merchandise

within the shopping centre and (especially where the tenant's own use clause does not restrict it to particular categories of merchandise).

(e) **Exempt Anchor Tenants**

No department store, or other major store will normally agree to be bound by exclusives that may be granted to other tenants within a shopping centre, except perhaps, other anchors of a different category from them. For example, a department store will normally agree not to operate as a food supermarket and vica-versa. However, no department store would normally agree to restrict itself from selling merchandise that is sold by smaller tenants.

(f) **Consider exempting small tenants**

If a large tenant operates a particular type of use, it may in fact be able to tolerate competition from a much smaller tenant. A 10,000 square foot athletic shoe shop tenant can easily withstand competition from a 1,000 square foot shoe store.

(g) **Consider restricting the ambit of the exclusive so it does not apply to the entire shopping centre**

For example, a yogurt store on the ground floor of major regional mall may be able to withstand competition from another yogurt store on a second level at the opposite end of the mall.

(h) **Consider limiting the duration of the exclusive**

A tenant may be willing to live with a limitation of its exclusive for the initial few years of its term to enable it to establish itself with a new concept or a new idea.

(i) **End the exclusive if the tenant defaults**

No tenant should be in a position to enforce an exclusive if it is in default under the lease in any material way. Also, once a default occurs and the exclusive use clause ceases to operate, the tenant should not be permitted to reinstate the exclusive as it relates to any space which the landlord may have leased to a competing use in the intervening period between the default and the cure of the default. Similarly, if the tenant defaults and during the period of the default, the landlord engages in bona fide negotiations with a third party competitor of the tenant, the landlord should be entitled to continue those negotiations and complete the lease with a new tenant even if the defaulting tenant remedies the default in the interim.

(j) **End the exclusive if the tenant discontinues the protected use**

If a tenant ceases operating its business within a premises, or ceases selling a particular category of merchandise in respect of which it has the benefit of an exclusive, the exclusive should fall. Similarly, the suspension of the exclusive should continue either indefinitely from the landlord's perspective or should at least enable the landlord to permit tenants to which it has leased space during the discontinuance to complete the terms of their leases (and any renewals of their leases) whether or not the tenant benefited by the exclusive resumes operation).

For tenants, it is best to attempt to achieve the converse of each of the suggestions noted above.

In addition, tenants should keep in mind cases such as *Nylar Foods Ltd. v. Roman Catholic Episcopal Corp. of Prince Rupert* (1988), 48 D.L.R. (4th) 175 (BCCA) at 176 which make it clear that a restrictive covenant such as an exclusive use clause needs to describe both a dominant tenement (a parcel of land such as the leased premises that is benefitted by the exclusive use restriction) and a servient tenement (a parcel of land which is subject to or burdened by the exclusive use restriction). Without this precaution, even if the exclusive is registered on title to the Shopping Centre lands (as it should be in all cases), it may not be enforceable against subsequent purchasers or owners of parts of the shopping centre lands

(3) ***Continuous Operating Covenant***

The following drafting notes should be considered by Landlords:

(a) **Require operation in the whole of the premises and without interruption**

The tenant should covenant to operate in substantially the whole of the premises continuously, without interruption.

(b) **Specify hours**

The hours of operation should be specified (if the tenant typically operates during hours that are not the same as other tenants in the shopping centre then, at least a minimum number of hours during each week should be specified).

(c) **Specify the type of business by reference to the use restriction clause**

The tenant should covenant to operate the particular type of business described in the use clause.

(d) **Enforcement is a problem**

Particular attention must be given to the default remedies in connection with continuous operating provision. The courts are reluctant to grant mandatory injunctions and obtaining an order requiring the tenant to continue to stay open and operate or for that matter requiring the tenant to stay open for at least a minimum number of months after the giving of notice of its intention to cease operating is difficult to achieve. In this regard see, "Courts Bless Going Dark - The Continuing Saga Of Operating Covenants" and, The Covenant of Continuous Operation "The Lights Are Flickering" by Ariella Rohringer of Goodman and Carr (attached.)

Other considerations concerning enforcement are as follows:

(e) **The Liquidated Damages Clause**

Typically, standard leases contain a clause under which the tenant agrees to pay to the landlord as liquidated damages, a specified per diem amount for each day during which it fails to carry on business in its store in accordance with the lease. These clauses are probably not enforceable because they are likely to be held to constitute a penalty. See *J.D.S. Investments Limited v. Neino* in The Ontario District Court - York Judicial District, April 1988, Court File # 244827/85, now reported at [1988] O.J. No. 793 (Dist.Ct.) (QL)

(f) **Cross Default Clause**

You may wish to consider including a clause so that if a tenant ceases operating in the leased premises, it will be considered as a default of its obligations under leases entered into with the landlord or related landlords in other shopping centre locations, so that, the tenant would be at risk of losing successful locations in other shopping centre, if it ceased operating in the leased premises.

(g) **Repayment of Inducements**

If the tenant ceases to operate the tenant should be required to reimburse to the landlord any inducement or other allowances and to pay to the landlord the value of any rent free periods which the landlord granted to the tenant as an inducement to come to the shopping centre and operate. The tenant should also be required to reimburse the landlord for any fees or commissions paid by the Landlord to third parties in connection with the lease.

(h) **Rent Increase**

It might be useful to include an acknowledgement by the tenant that the basic rent has been structured to reflect the benefit to the landlord of the tenant's continuous operation within the shopping centre. If the tenant ceases operating, the basic rent will be increased to a pre-agreed higher basic rent that reflects the rental rate at which the space would be leased to a tenant, where there is no opportunity for the landlord to obtain percentage rent or to benefit from the synergy of an active business operating within the premises. There is still a risk that such a provision may be treated as a penalty but, an expressed acknowledgement such as this may go a long way toward reducing that risk.

(i) **Exemption of Landlord's Obligations**

The tenant should acknowledge that if it ceases operating in contravention of the continuous operating covenant, (i) the landlord's obligations to operate the shopping centre in accordance with first class standards, (ii) any restrictions on the landlord's rights to modify or redevelop the shopping centre, (iii) covenants on the part of the landlord pertaining to parking ratio requirements, repair obligations, restrictions on modifying the common elements, and (iv) any rights of approval that the tenant might have in connection with the leasing of other spaces in the shopping centre, including but not limited to any exclusive non-competition provisions should terminate.

(j) **Radius Restriction Arising on Cessation of Operation**

The landlord may consider a clause that imposes a radius restriction on the tenant that arises only if the tenant ceases operating under the terms of this lease. (Such a clause is not necessary if the lease contains a radius restriction that would apply in any event.)

From a tenant's perspective the following should be noted:

(i) *Co-occupancy Requirements*

The tenant may wish to limit its continuous operating covenant so that unless there is a minimum number of other tenants within a shopping centre, who are continuously operating businesses consistent with a first class shopping centre, the tenant's obligation to operate would be suspended or ceased;

(ii) *Limit on Required Hours of Operation*

The tenant may also wish to restrict its hours of operation so that it does not have to operate when key, major tenants within a shopping centre are not operating.

(iii) *Right to Cease Operating When Material Part of the Shopping Centre is Not Functioning*

Where there is substantial damage to the rest of the shopping centre or a material part of the common areas is not available, the tenant may wish the right to cease operating.

(iv) *Preserve Landlord's Obligations to Operate the Shopping Centre*

The tenant would be well advised to resist any suggestion by the landlord that the landlord's obligations to operate the shopping centre while the tenant is not operating should be relaxed (if the tenant has ceased operating in accordance with a right to do so such as those noted above). The landlord's failure may impede the tenant's ability to assign or to sublet or obtain a replacement that would be willing to operate within the leased premises.

**(4) - Radius Restrictions**

To protect the landlord's shopping centre against competition from other shopping centre operators within the vicinity, and to preserve percentage rents it is normal to include in a standard lease form a restriction against the tenant opening for business, within a radius of a stated number of kilometres or, (depending on the nature of project) a stated number of meters from the shopping centre. In dealing with radius restrictions, the following notes should be considered:

**(a) The Radius must be Specifically Negotiated**

Care should be taken to negotiate the particular radius on an individual lease by lease basis, rather than relying upon a standard radius restriction within a standard lease form. This is because a radius restriction that is an unreasonable restraint on trade will not be enforced. If the landlord cannot demonstrate that the parties actually applied their minds to what a reasonable radius should be, the landlord is at risk of having the restriction struck down. For the same reasons, care must be taken not to impose a radius restriction that is so wide that it provides to the landlord a degree of protection that is unreasonable.

(b) **Apply the Radius to Entities Related to Tenant**

From a landlord's prospective the radius restrictions needs to be drafted so that it applies not only to the tenant, but also to affiliates, related companies, and other entities over which the tenant exercises control. Here again care must be taken not to extend the ambit of so wide that it constitute an unreasonable restraint of trade. For example, a prohibition against the tenant having a financial interest or an equity interest in any entity within the prohibited radius, would likely be struck down as unreasonable.

(c) **Consider Existing Stores of the Tenant and the Possibility of the Tenant Buying a Chain of Stores**

The tenant should be concerned about agreeing to restrict itself from operating other stores within the area if it already has stores within the restrictive radius. This is particularly important if it operates other categories of store that are not really in competition with the particular type of store that the tenant operates, within the shopping centre. The tenant may also wish to acquire stores from other companies that already exist in the restricted area.

(5) ***Assigning and Subletting***

The restrictions on assigning, subletting, transfers and other dispositions that are contained in a typical lease, must be scrutinized carefully, having regard to the need of the tenant to change its use of the premises should it wish to sell its business. As noted above, if the tenant restricts itself to operating according to a particular business style and trade name, its ability to market its business should it wish to sell it, becomes greatly restricted. The following suggestions should benefit tenants:

(a) **Allow the tenant to change to a compatible use**

So long as the new use for the premises is compatible to the mix of tenants in the shopping centre at the time of a proposed assignment or sublease, the tenant should be able to make the change.

(b) **Allow the tenant to subdivide its space**

A large tenant should also take into consideration whether it may be necessary for them to sub-divide their space in order to minimize their rent exposure should they wish to cease operating.

(c) **Allow for a change in business hours**

If there is a change of use the need to change the hours of operation that bind the tenant should also be considered.

Note however, that case law distinguishes between a default which is of a continuing nature and one that is not. In text, *Anger and Hansberger Law of Real Property* at page 280, states:

"covenants to repair, to insure, to cultivate or to use the premises in a particular manner have been held to be continuing covenants and the omission to observe this is a continuing breach. A covenant which requires the complete performance of a definite act within a specified time is not a continuing covenant"

It is likely that a breach of a continuous operating covenant is a continuing default and that after accepting rent a notice of default could be re-issued and termination could occur if the tenant failed to re-open within the cure period.