

Exclusive-Use Covenants Often Restrict Retail Leases

by Carol C. Honigberg, JD

Exclusives, or restrictions imposed upon the permitted activities of tenants for the benefit of an anchor or other significant tenant, are fairly common in retail leases. A recent case decided by the U.S. Court of Appeals for the District of Columbia Circuit, *Red Sage Ltd. Partnership v. DespaEuropa*, addresses several issues that can arise when dealing with retail exclusive-use provisions.

Determining Exclusive Use

Red Sage, a restaurant serving southwestern-style food, leased space in a downtown Washington, D.C., building in 1990. The landlord had an ownership affiliation with Red Sage and the lease was not negotiated at arm's length, which means the agreement was not tied to market conditions because of the parties' affiliation.

The lease contained an exclusive-use clause in Section 34 stating "that during the term [the landlord] shall not permit any other tenant within the building to operate a bar, restaurant, or food service establishment of any kind (a 'competing use')." The clause was enforceable "so long as tenant is operating a bar and/or a restaurant in the leased premises."

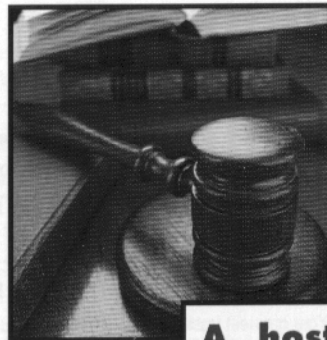
The clause continued, "In the event that a competing use is operated in the building at any time during the term and landlord has violated its covenants ... then (i) one-half of the base rent payable hereunder shall be abated during the period that the competing use is operated in the building, and (ii) tenant may terminate this lease if the operation of the competing use continues for a period of six months after written notice thereof by tenant to landlord. The provisions of this subsection shall not limit ... any other remedies, which tenant may have against landlord for violating its obligations."

Six years later, the lease was amended and restated in arm's-length negotiations but included the same exclusive-use covenant. The tenant-use clause was revised, however, to state that "tenant use and occupancy of the leased premises shall consist of owning and operating a restaurant and bar and carrying on any and all activities incidental or related thereto, including, but not limited to, operating a retail general store primarily selling T-shirts, sweatshirts, souvenirs, spices, baked goods, foods, and other items related to tenant's bar and restaurant."

In 1997, in conjunction with sale of the building to DespaEuropa, the lease was amended, but the exclusive-use, tenant-use, and rent abatement provisions were left intact. A DespaEuropa representative signed the amended lease.

The following year space in the building was leased to a specialty store known as Cakes & Co. The Cakes lease originally allowed for a "bakery/café" selling "specialty cakes, baked goods, coffee, non-alcoholic beverages and associated paper goods." The lease subsequently was amended by deleting the reference to a café and providing that food items could be sold only for consumption off the premises.

Some time after Cakes & Co. began operations in the building, Red Sage wrote to the landlord asserting that it had violated the exclusive-use covenant and requested the 50 percent rent abatement. In its response, Despa implied that the bakery's operations did not constitute a competing food service. Red Sage subsequently filed suit, alleging breach of Section 34 of the lease.



A host of legal issues may be present in dealing with exclusive-use clauses.

The Court Decides

Each side agreed upon the facts of the case, and each argued that it was entitled to prevail as a matter of law. The Federal District Court disagreed, indicating that the scope and coverage of the exclusive-use covenant was a material question of fact that could not be determined by the court. A material question of fact is a disputed issue on which the court needs to hear testimony before deciding the case.

Despa subsequently renewed its motion for summary judgment, but this time argued that the rent abatement provision constituted an unenforceable penalty as a matter of law. The District Court agreed and ruled in Despa's favor. Red Sage appealed the case to the D.C. Circuit Court.

After analyzing the provision, which refers to rent abatement as one of the remedies available to the tenant, the court first concluded that the rent abatement provision constitutes liquidated damages. The court then turned to an analysis of when liquidated damages are enforceable and when they are

deemed a penalty and not enforced. In the District of Columbia, the provisions of the code governing leases provide that liquidated damages in a lease are permissible, but only for an amount deemed reasonable in light of anticipated harm.

Applying these standards, the court found that damages resulting from breach of the exclusive covenant would be difficult to ascertain. Despa argued that a 50 percent rent reduction was not reasonable in relation to the anticipated damage from a competitor such as Cakes & Co. The court pointed out, however, that the competitor could have been another large-scale bar and restaurant and found that the exclusive-use covenant was intended to ensure that Red Sage was the only bar, restaurant, or food service establishment in the building. It then concluded that a 50 percent reduction in Red Sage's base rent was reasonable as a single formula to estimate damages from a wide variety of possible competing uses.

Continuing Appeals

Despa made several other attempts to avoid the rent abatement provision, first arguing that Cakes & Co. did not constitute a "food service establishment of any kind" and also arguing that if the bakery was subject to the exclusive-use covenant, such a provision constituted an unreasonable restraint of trade.

On the first point, the Court of Appeals agreed with the lower court's determination that the nature and scope of the exclusive-use covenant and the exact nature of the services provided by Cakes & Co. were disputed issues of fact.

On the second point, the court pointed out that covenants restricting or limiting competition are valid when ancillary to some other legitimate interest. In this case, the court found that the restriction was ancillary to the landlord-tenant relationship. Such restrictions cannot be overbroad or they will be deemed invalid. Here, however, the restriction was limited to the duration of the Red Sage lease, limited to the building, and restricted only other food service activities, not all retail activities. The court found this to be a reasonable limitation.

The court ordered the case remanded to the District Court to determine if Red Sage was entitled to the rent abatement in light of the lease language, the parties' intent, and the nature of Cakes & Co.'s operation.