

## A Fresh Look at Restrictive Use Covenants in Retail Leasing

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Restrictive covenants are an important tool in commercial leasing. Two of the most common varieties of restrictive lease covenants—exclusive use covenants and prohibited use covenants—seek to constrain a landlord’s right to permit particular uses in a multi-tenant property.<sup>2</sup> More commonly used in retail than office, exclusive use covenants seek to protect a tenant from competition by requiring the landlord to promise that it will not lease space in a specified area to a business selling certain goods or services.<sup>3</sup> Prohibited use covenants seek to protect the tenant from a variety of objectionable uses in a specified area. As discussed in Section III, uses may be objectionable to particular tenants for different reasons.<sup>4</sup>

Many retail tenants believe that exclusive use covenants and prohibited use covenants are essential to the success of their businesses. Landlords obviously prefer to have unfettered control over the distribution of uses in a multi-tenant property; they therefore dislike any limitations on their freedom to choose tenants. However, it has become standard for landlords to grant some restrictive covenants with respect to use. Tenants with greater bargaining power can extract broader covenants from landlords.

Exclusive use covenants and prohibited use covenants are so deeply ingrained in retail leasing that they have almost become part of the boilerplate of many tenant and landlord forms. As a result, many leasing attorneys have become lulled into a false sense of complacency regarding the standard formulations of these types of restrictive covenants. Although courts do not often have occasion to consider the interpretation, enforceability, and remedies for the breach of these covenants, they often reach surprising conclusions that run contrary to the expectations of leasing attorneys and their clients. This article examines recent appellate decisions and proposes that transactional attorneys should take a fresh look at their exclusive use and prohibited use provisions in order to craft more resilient covenants that will more predictably and efficiently meet client needs.

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<sup>2</sup> See VINCENT DiLORENZO & CLIFFORD R. ENNICO, BASIC LEGAL TRANSACTIONS § 7.9 (2010).

<sup>3</sup> See *id.*

<sup>4</sup> See *id.*

## I. Overview of Restrictive Covenants in Leases

Although the word “covenant” is used colloquially to mean any promise, at common law, the word has a very specific meaning—it is a written promise to take an action or to refrain from taking an action.<sup>5</sup> A personal covenant is contained in a written contract. If one party breaches a personal covenant, the non-breaching party may be entitled to the specific remedies set forth in the contract or, if the contract does not stipulate remedies, money damages.<sup>6</sup> A personal covenant is always binding upon the original parties to the contract and, if permissible under the terms of the contract, the covenant may also bind the successors and assigns of the original parties.<sup>7</sup>

### A. Interpretation Standards

As a general principle, a landlord may restrict the use of property through a restrictive covenant so long as such restrictions are not illegal or unconscionable.<sup>8</sup> Restrictive covenants contained in a retail lease are interpreted in accordance with general contract principles. If the language is clear and unambiguous, then courts will construe the terms by their ordinary and usual meaning.<sup>9</sup> However, if there is ambiguity, restrictive

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<sup>5</sup> 9-60 POWELL ON REAL PROPERTY § 60.01 (“A covenant is an agreement or promise of two or more parties that something is done, will be done, or will not be done.”)

<sup>6</sup> See Alan Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271, 271-2 (1979) (“The purpose of contract remedies is to place a disappointed promisee in as good a position as he would have enjoyed had his promisor performed. Contract law has two methods of achieving this ‘compensation goal’: requiring the breaching party to pay damages, either to enable the promisee to purchase a substitute performance, or to replace the net gains that the promised performance would have generated; or requiring the breaching party to render the promised performance. Although the damages remedy is always available to a disappointed promisee under current law, the remedy of specific performance is available only at the discretion of the court. Moreover, courts seldom enforce contract clauses that explicitly provide for specific performance in the event of breach. ... Under current law, courts grant specific performance when they perceive that damages will be inadequate compensation. Specific performance is deemed an extraordinary remedy, awarded at the court’s discretion.”)

<sup>7</sup> See, e.g. *Warrender v. Gull Harbor Yacht Club, Inc.*, 747 S.E.2d 592, 600 (N.C. Ct. App. 2013) (“Because covenants originate in contract, the primary purpose of a court when interpreting a covenant is to give effect to the original intent of the parties; however, covenants are strictly construed in favor of the free use of land whenever strict construction does not contradict the plain and obvious purpose of the contracting parties. ... In construing restrictive covenants, the fundamental rule is that the intention of the parties governs, and that their intention must be gathered from study and consideration of all the covenants contained in the instrument or instruments creating the restrictions.”)

<sup>8</sup> See *Cox v. Simon*, 651 A.2d 476, 483 (N.J. Super. Ct. App. Div. 1995) (“a restrictive covenant within a commercial context may be enforced if found reasonable”).

<sup>9</sup> See, e.g., 11 RICHARD A. LORDE, WILLISTON ON CONTRACTS § 30:1 (4th ed. 2012). See also *E. Pride, Inc. v. Singh*, 760 S.E.2d 94, 96 (N.C. Ct. App. 2014) (“[u]nless the covenants set out a specialized meaning, the language of a restrictive covenant is interpreted by using its ordinary meaning. ... A dictionary with the copyright date on or about the time the restrictive covenant was executed ‘is an appropriate place to ascertain the then customary definitions of words and terms.’”)

covenants will be strictly construed and ambiguities will be resolved in favor of the free and unfettered use of property.<sup>10</sup>

If the lease clearly and unambiguously expresses the intent of the parties, courts will confine their interpretation to the four corners of the lease.<sup>11</sup> If the language is not clear and unambiguous, courts will resolve ambiguity in a lease covenant: (i) by examining parol evidence to ascertain the intent of the parties; (ii) in light of the “customs, practices, and terminology as generally understood by a particular trade or business;” and (iii) in a commercially reasonable manner. Contract language is not ambiguous simply because the two parties disagree about its meaning.<sup>12</sup> Instead, one often-cited judicial definition of ambiguity is as follows:

An “ambiguous” word or phrase is one capable of more than one meaning when viewed objectively by a reasonably intelligent person who has examined the context of the entire integrated agreement and who is cognizant of the customs, practices, usages and terminology as generally understood in the particular trade or business.<sup>13</sup>

Ambiguous covenants that restrict the use of real property are subject to additional scrutiny. In a 2014 case, the North Carolina Court of Appeals explained:

“[A]ny ambiguities in the restrictions are to be resolved in favor of the free and unrestricted use of the land.” ... That is, as our Supreme Court has explained, any doubt should be resolved in favor of “the unrestricted use of property, so that where the language of a restrictive covenant is capable of two constructions, the one that limits, rather than the one which extends it, should be adopted, and

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<sup>10</sup> See, e.g., *Fratelli's Pizza & Rest. Corp. v. Kayzee Realty Corp.*, 902 N.Y.S.2d 534, 535 (N.Y. App. Div. 2010) (quoting *Bear Mtn. Books v. Woodbury Common Partners*, 649 N.Y.S. 2d 167, 168 (N.Y. App. Div. 1996)) (“restrictive covenants in leases, such as use clauses, are ‘strictly construed against those seeking to enforce them’ and that ‘where there are two equally plausible interpretations of a restrictive covenant, the less restrictive interpretation will be adopted’”); *E.M.R. Mgmt. Corp. v. Halstead Harrison Assocs.*, 749 N.Y.S.2d 569, 570–71 (N.Y. App. Div. 2002) (“It is well settled that the law favors the free and unobstructed use of real property. Covenants restricting the use of property are strictly construed against the party seeking to enforce them. Restrictive covenants such as ‘use clauses’ in leases should be enforced according to the intent of the parties, which will be primarily determined from the lease. The burden of proof is on the party seeking to enforce the restrictive covenant, and the existence and scope of the covenant must be established by clear and convincing evidence.”) (citations omitted); *Iggy's Doughboys, Inc. v. Giroux*, 729 A.2d 701, 706 (R.I. 1999) (“Although restrictive covenants in Rhode Island leases are governed by the same rules as covenants generally, such covenants are not favored by the law and will be strictly construed. We shall enforce a restrictive covenant, however, if it is reasonable in light of the circumstances surrounding the agreement and does not extend beyond what is apparently necessary to protect its beneficiaries.”) [citations omitted].

<sup>11</sup> See, e.g., *Middletown Square Associates, LLC v. Jasinski*, 2012 WL 6042639 (2012)

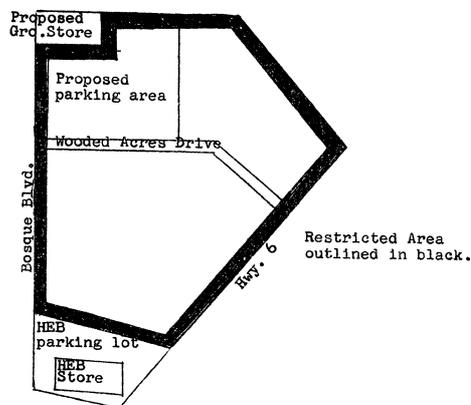
<sup>12</sup> See *Bristol-Myers Squibb Co. v. Ikon Office Solutions, Inc.*, 295 F.3d 680, 684 (7th Cir. 2002).

<sup>13</sup> *Walk-In Med. Ctrs., Inc. v. Breuer Capital Corp.*, 818 F.2d 260, 263 (2d Cir. 1987) (quoting *Eskimo Pie Corp. v. Whitelawn Dairies, Inc.*, 284 F. Supp. 987, 994 (S.D.N.Y. 1968)).

that construction should be embraced which least restricts the free use of the land.” ... This “rule of strict construction is grounded in sound considerations of public policy: It is in the best interests of society that the free and unrestricted use and enjoyment of land be encouraged to its fullest extent.”<sup>14</sup>

It is often difficult to predict whether courts will find language to be clear or ambiguous. Consider two similar cases from North Carolina and Texas.<sup>15</sup> Both cases involved an exclusive use covenant benefiting a tenant—CVS in North Carolina and a grocery store in Texas. Both covenants used similar language whereby the landlord promised to not allow the burdened parcel of land “to be used for the purpose” of specific competing uses. Each case arose after the landlord utilized the burdened parcel for parking to support an adjoining parcel of land that was not burdened by the covenant.

In the Texas case, the HEB grocery store was granted a restrictive covenant that reads in relevant part as follows: “For benefit of HEB, its successors and assigns, [Landlord] hereby places the following restrictions [on the burdened parcel] ... against the use of any portion thereof for the purpose of conducting thereon a foodstore or food department for the storage or sale for off-premises consumption of groceries, meats, produce, dairy products, frozen foods, baking products...”<sup>16</sup> The landlord sold real estate burdened by the restrictive covenant to a developer that planned to use it for parking to support a new grocery store, as depicted in the below drawing:



The Texas court concluded that such use of the burdened parcel violated the exclusive use covenant:

<sup>14</sup> *E. Pride, Inc. v. Singh*, 760 S.E.2d 94, 96 (N.C. Ct. App. 2014)

<sup>15</sup> The real covenants at issue in these disputes were recorded and ran with the land, however, they were enforced against the original parties. Any difference in the interpretation standard triggered by the recording of the covenants does not negate the use of these cases to illustrate the discussion of restrictive use covenants in retail leases.

<sup>16</sup> *H. E. Butt Grocery Co. v. Justice*, 484 S.W.2d 628, 629 (Tex. Civ. App. 1972), writ refused NRE (Jan. 10, 1973).

The restriction is “against the use of any portion thereof for the purpose of conducting thereon a foodstore”. Manifestly the purpose of such restriction was to prohibit the restricted tract from being used as any necessary part of a competing supermarket with HEB. ... The proposed foodstore cannot be conducted without the use of the restricted area. Parking, ingress, egress, delivery of groceries to customers cars, are all under the record essential to conducting the proposed foodstore, and all would take place on the restricted tract. ... The parking lot is thus an integral part of the proposed operation. The foodstore cannot be conducted without it. ... [J]udgment [is] rendered declaring plaintiffs’ proposed use of the restricted tract violative of the restricted covenants.<sup>17</sup>

In the North Carolina case, CVS was granted a restrictive covenant that reads in relevant part as follows: “During the term of the existing CVS lease ... no owner of any portion of the [Burdened] Tract shall allow its parcel to be leased or to be used for the purpose of a health and beauty aids store, a drug store, a vitamin store, and/or a pharmacy.”<sup>18</sup> The landlord entered into a contract to sell the burdened parcel to a developer who intended to use the burdened parcel as parking to support a Wal-Mart that it was building on an adjacent and unburdened parcel. The court noted that it was required to strictly construe restrictions on the use of real estate and that “nothing can be read into a restrictive covenant enlarging its meaning beyond what its language plainly and unmistakably imports.” It acknowledged the Texas case, but then sharply deviated from that case’s resolution.

In the instant case, we interpret the restrictive covenant to prohibit exactly what it purports to ban on the face of the restriction—the erection of a *structure* on the [burdened] tract that operates as a prohibited type of retail store, namely a pharmacy. Thus, a developer may not build a store—four walls and a roof—that constitutes a vitamin store, beauty aid store, or pharmacy. We do not believe that the intent of the grantor ... was to outlaw the construction of those things which are integral or essential to the *operation* of a retail business. If such prohibition was intended, the drafter could have said as much by incorporating phrases such as “used for store purposes” or “used for purposes incidental to a store.” However, without more, we conclude the construction of a parking lot and access easement on the restricted property is not a prohibited use.<sup>19</sup>

Both courts utilize the same general common law standards with respect to recognizing and resolving ambiguity. Both examined similar language, and yet they arrived at opposite conclusions regarding its meaning. It is hard for me to imagine that the CVS attorneys anticipated that the restrictive covenant could have been interpreted to permit

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<sup>17</sup> *Id.* at 630-631.

<sup>18</sup> *Charlotte Pavilion Rd. Retail Inv., L.L.C. v. N. Carolina CVS Pharmacy, LLC*, 767 S.E.2d 105, 106 (N.C. Ct. App. 2014)

<sup>19</sup> *Id.*