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COMMERCIAL LEASING: ESSENTIAL ISSUES
PAPER 5.1

Key Restrictions on Use and Competition

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KEY RESTRICTIONS ON USE AND COMPETITION[1]

I. Introduction

A. Use and competition clauses have long been important aspects of commercial leases. Their significance has increased, however, as the ever-expanding variety of products and services that modern businesses wish to offer has led to increasing litigation.

B. For landlords who wish to avoid such expansion in a tenant's use clause, the key drafting lesson emerging from the case law is to limit permitted uses by reference to type of product or activity rather than type of business or store. Tenants, on the other hand, may wish the latter type of description and "expanding the use" language, such that, if the character of their type of business expands over time, these expanded uses will be permitted by their use clause and protected by their restrictive covenant.

C. The other key lesson from the cases is that the lease language matters. There is no boilerplate approach to the types of clauses considered in this paper. The outcome of the cases turns on the precise words used in the clauses in question, often with reference to other clauses in the lease. For this reason, careful drafting can create an advantage for clients, be they landlords or tenants, in the important context of the use of the premises and competition amongst tenants.

II. Use Clauses

A. Defining the permitted uses—or, from the landlord's perspective, the restrictions on uses—is essential for any lease. It is particularly significant for multiple-tenant retail premises, such as shopping malls, where landlord and tenant share the goal of creating a combination of complementary, rather than conflicting businesses.

B. Often for the landlord, the goal is to define the permitted use as specifically and narrowly as possible. A landlord granting broad use clauses to tenants of multi-unit complexes will invariably face problems between tenants, particularly if the tenants also obtain restrictive covenants.

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C. In retail leases, use clauses have come to focus more on the type and range of products that may be produced or sold, as opposed to the type of business that may be conducted. This stems from the changes which have occurred in retail outlets. In many cases, there is no longer a commonly accepted definition of, or limitation on, what products particular types of businesses sell; or even if the limits are currently known, they may soon expand.

D. *Geoffrey L. Moore Realty Inc. v. Manitoba Motor League*, 2003 MBCA 71, is a good example of judicial interpretation techniques for use clauses and restrictive covenants. The issue was whether the tenant, Manitoba Motor League, was entitled to sell home insurance from its shopping centre location. Another tenant had a restrictive covenant for the exclusive right to do so. The Manitoba Motor League lease permitted uses included "... full services of a Manitoba Motor League outlet." The tenant argued that the use clause prohibited it from providing only services it provided nowhere else, and it did in fact sell home insurance at another location. The Court granted a permanent injunction, however, restraining MML from selling home insurance on the basis that: protection of the premises as an auto club/travel agency in the exclusive use restrictive covenant was indicative of the types of services it would provide; MML did not provide home insurance at the time of making the lease; and the clause was not open-ended and flexible allowing it to alter its range of services as they expanded. The injunction was granted to the landlord because it amounted to enforcement of a negative covenant without any evidence that the balance of convenience favoured the tenant.

E. To summarize, the techniques applied by the Court to interpret the use clause were whether:

1. the clause refers to a type of business or a type or range of products;
2. the use is static as of the date of the lease, or made flexible by the use of the words such as "from time to time"; and
3. the use clause is modified or restricted by reference to exclusion of uses permitted to other tenants (i.e., any restrictive covenants on the landlord).

F. Plain and ordinary meaning of words will override dictionary definitions. In *Mission City Holdings Ltd. v. Jim Pattison Industries Ltd.*, 2000 BCCA 302, the Court held that a food liquidation store did not fall within the permitted use of "grocery store and super-market business" because it was not a full service store with a full range of products. The issue was whether the tenant, Save On Foods, could replace its standard store with a food liquidators business on the premises. The Court of Appeal held that the liquidation operation, though it did accord with some dictionary definitions of "grocery store and super-market," did not accord with the plain ordinary and popular meaning of that phrase because the liquidation store did not offer a full or predictable range of products and the products were discounted for reasons affecting their desirability. The tenant was ordered to deliver vacant possession under the default provisions in the lease.

G. The communications leading to the lease document and the parties' subsequent conduct will often be important for interpretation of ambiguous clauses. In *389079 BC Ltd. v. Coast Hotels Ltd.* (1998), 63 B.C.L.R. (3d) 359 (S.C.), the tenant operated a fitness centre under a use clause allowing a squash and racquet ball club together with (among other things) a members' lounge. The landlord terminated the lease on the basis the tenant had breached by sub-letting the lounge, without consent, for live entertainment for the general public. The tenant's action for wrongful termination was successful. The Court held the lounge was not sublet but licensed to a management company which did not have exclusive rights of possession. The lounge was not being put to improper use as the use clause did not prohibit live entertainment or public access to it and the correspondence and conduct between the parties indicated it was well understood that the club could serve the public in the lounge and offer live entertainment. In fact, the landlord did not object to the use of the lounge for live entertainment until it made the decision to change the image and operation of the hotel. The tenant was awarded general damages of $300,000 and punitive damages of $100,000 for wrongful termination of its lease.

H. *1536165 Ontario v. Toronto Economic Development Corp.*, [2004] O.J.N.O. 1151 (Ont. S.C.J.) is a good example of the court examining the factual matrix to construe a difficult use clause. The use clause permitted "...the purposes of *grocery store with an ancillary parking lot and other retail uses* and for no other purposes whatsoever, no bars, clubs, licensed premises or other use shall be permitted." The tenant sought a declaration that its use clause permitted any retail use under the zoning bylaws. The landlord sought a declaration that the lease permitted no uses other than a grocery store with ancillary retail uses. The Court stated that the proper question to ask was:

> Bearing in mind the relevant background, the purpose of the document, and considering the entirety of the document, what would the parties to the document reasonably have understood the contested words to mean?

I. Upon examination of the exchange of drafts of the lease and the uncontested evidence that the purpose of the clause was to remain competitive with other similar food businesses by providing an expanded retail food terminal as primary use, with support retail uses that complemented this major use, the court concluded that "other retail uses" permitted under the lease were only to be those ancillary or supportive of the primary grocery store use.

J. Perhaps the best example in the case law of the trend of businesses expanding beyond their traditional products and services, thereby creating litigation surrounding use clauses and restrictive covenants, is grocery stores seeking to incorporate pharmacies. The cases suggest there is no generally applicable answer to whether a pharmacy can be opened under a grocery store use clause. Instead, the outcomes turn on the application of the particular facts to the specific words of the lease.

K. In *Goodman Rosen v. Sobeys*, 2003 N.S.S.C. 62, the landlord's receiver obtained a permanent injunction restraining the tenant from operating a pharmacy in its supermarket. The tenant's lease provided it could use the premises only for retail sale of food products "... as well as general retail merchandising, as carried on by the rest of the majority of its stores." Shopper's Drug Mart, another tenant in the mall, had a covenant that the landlord would not permit any other space in the mall to be used as a pharmacy. The Court held that operating a pharmacy was not within "general retail merchandising" which referred to the business of selling merchandising in great variety. The prominence and professional services of a pharmacy took it out of general retail merchandising and, as such, adding a pharmacy was far different from merely adding a new line of product, and in any event pharmacies were not found in the majority of the tenant's stores.

L. The opposite result occurred in *Cadillac Fairview Corporation Limited v. Canada Safeway*, [1991] R.P.R. (2d) 250 (B.C.S.C.). The plaintiff shopping mall owner sought a declaration that a pharmacy and drug department by the defendant Canada Safeway breached the Safeway Lease and the Shopper's Drug Mart Lease. It also sought a permanent injunction restraining Canada Safeway from operating a pharmacy and drug department contrary to the provision of its lease and damages. The lease clause was permissive. It stated that "Approved Business means the retail sale of supermarket goods and services with at least 40% of the product and services being food for off-premises consumption."

M. The Court concluded this language was broad enough to allow any business on the premises that became part of the operation of a supermarket in general during the course of the lease, which pharmacies had done, provided that 40% of the merchandise offered for sale consisted of food for off-premises consumption. The Court also held that the landlord could not enforce the restrictive covenant in the Shopper's Drug Mart lease against Safeway. The Court held that there was no community of interest when the exclusive right to operate a drugstore in the Shopper's lease had no corresponding restrictive covenant in the Safeway lease and where the Shopper's Lease contemplated possible pharmacy uses by previous anchor tenants.

N. In *London Drugs Ltd. v. Truscan Realty Ltd. et al.*, [1988] B.C.J. No. 1366 (S.C.), London Drugs and Overwaitea Supermarket leased portions of a shopping centre in Kelowna from Truscan. The London Drugs lease contained a restrictive covenant precluding any other tenant from selling

prescription drugs. The Overwaitea lease, made later, stated the tenant would use its premises only for the operation of a food supermarket. London Drugs sought to enforce its restrictive covenant by an injunction and damages against Overwaitea and damages for breach of contract against Truscan. Truscan brought third party proceedings against Overwaitea to enforce a restrictive covenant in its lease. The Court granted a permanent injunction against Overwaitea's operations of a pharmacy. At the time of the lease, Food supermarkets did not include pharmacy. London Drugs was held to have standing to enforce the terms of Overwaitea's lease on the basis there was a community of interest between the tenants in the mall.

III. Operating Covenants

A. Many retail leases contain what is called an "operating covenant" providing that the tenant will not only pay rent and abide by the lease terms (the traditional view of what landlords care about) but also operate and carry on business throughout the term of the lease. Often the operating covenant will stipulate that the premises remain open during the business hours of the complex.

B. Of particular importance to landlords are operating covenants for anchor tenants. If an anchor tenant closes its doors, not only the landlord but the other tenants in the complex will suffer a significant financial loss and even business failure.

C. In general, courts will not imply an operating covenant as a term of the lease. But see *Nickel Developments Ltd. v. Canada Safeway Ltd.*, 2001 MBCA 79 where a continuous use clause was implied due to the tenant being an original anchor tenant of the mall and the court's dissatisfaction with the tenant's tactical exercise of its renewal rights for the purpose of keeping the premises vacant to prevent occupation by a competitor.

D. Courts will not generally order specific performance of the operating covenant because of the adequacy of damages and difficulties of supervising the operation of the tenant's business (*Vista Sudbury Hotel Inc. v. Zellers Ltd.*, [2004] O.J. No. 2206 (S.C.)). In *Vista*, the Court declined to grant an interlocutory injunction preventing Zellers from closing an operation that was neither profitable nor compatible with the operating strategy of the company. Even though Zellers' closing was likely to cause financial difficulties for the remaining tenants, and possibly even the closure of the entire shopping complex, it had only became an anchor by default, and the court was unwilling to force a tenant to continue to operate in a place it did not want to be and at a loss.

E. The Court did grant an injunction restraining an anchor store from ceasing operations in *Bentall Properties Ltd. v. Canada Safeway Ltd.*, [1988] B.C.J. No. 775 (S.C.). Safeway was planning on closing its location due to losses. Bentall applied for an interlocutory injunction to prevent the closure based on the operating covenant in the lease. The Court granted the interlocutory injunction based on the "special circumstances" in the case, including:

1. the defendant's status as an anchor tenant in the mall;
2. integration of the defendant into the shopping centre's trucking, warehouse and purchasing systems;
3. the loss of the defendant as an anchor tenant threatening a domino effect with other tenants whose leases permitted termination if an anchor tenant ceased operations;
4. the difficultly in enforcing the operating covenants of the other anchor tenants;
5. threat by a second larger anchor tenant that it would also close its store if Safeway was permitted to close;
6. the adverse effect the defendant's departure would have on the ability of the landlord to negotiate new leases with those tenants whose leases were up for renewal in the next year or two;

7. some tenants would be able to stop paying basic rent upon the departure of the defendant and only pay percentage rent; and

8. the virtual impossibility of replacing tenants that might cease operating due to the defendant's departure.

IV. Restrictive Covenants

A. A tenant will normally request a restrictive covenant for its benefit in multi-unit complexes to preclude other tenants from impinging on its business. Landlords must avoid one tenant's restrictive covenant being at odds with the use clause in another tenant's lease. For example, a use clause may be so broad that it violates the restrictive covenant contained in another tenant's lease.

B. Because of their anti-trade aspect, and because other tenants needs to be able to predict their application, a restrictive covenant "must not be stretched beyond the ordinary meaning of the words." *Stuart v. Diplock Bros.* (1889), 59 L.J.Ch. 142 (C.A.).

C. The problems most often associated with drafting restrictive covenants are as follows:

1. not excluding the business, or possible business, of current tenants, particularly anchor tenants;

2. not excluding the business, or possible business, of potential future anchor tenants;

3. not excluding the business, or possible business, of current tenants, particularly anchor tenants, on renewal terms;

4. not defining clearly the scope of the restriction; and/or

5. confusing a type of business with a type of product.

Richard Olson, *A Commercial Tenancy Handbook*, looseleaf (Toronto, Ont.: Thomson Canada Limited, 2004) at para. III.E.d.iii

D. In *Russo v. Field*, [1973] S.C.R. 466, the plaintiff/tenant's lease precluded the landlord from leasing to other tenants in the hairdressing or beauty salon business and confirmed that the stores in the shopping centre should be non-competitive. The landlord subsequently leased neighbouring premises to a wiggery. The evidence at trial was that, at the time of the plaintiff's lease, the selling and servicing of wigs was a usual part of the hairdressing business. The Supreme Court of Canada stated:

> It has been said that covenants such as those under consideration in this action are covenants in the restraint of trade and therefore must be construed restrictively. I am quite ready to recognize that as a general proposition of law and yet I am of the opinion that it must be considered in the light of each circumstance in each individual case. The mercantile device of a small shopping centre in a residential suburban area can only be successful and is planned on the basis that the various shops therein must not be competitive. Since the shopping centre is a local one and not a regional shopping centre, the prospective purchasers at the various shops which it is planned to attract are residents in the neighbourhood. They are, of necessity, limited in number and therefore the business which they bring to the shopping centre is limited in extent. The prospective purchaser attracted to shop A in the plaza may well turn from shop A to shop B to purchase some other kind of his or her needed goods or service but if the limited number of prospective purchasers are faced in the same small shopping centre with several prospective suppliers of the same kind of goods or service then there may not be enough business to support several suppliers. They will suffer and the operator of the shopping plaza will suffer.

> I am therefore of the opinion that the disposition as a matter of public policy to restrictively construe covenants which may be said to be in restraint of trade has but little importance in the consideration of the covenants in the particular case.

E. In *Luu v. Sinbads Hallel Meats* (2006), 50 R.P.R. (4th) 302 (Ont. S.C.J.), Luu, a grocery store tenant sought to enforce a restrictive covenant restraining the use of any unit in the mall to the original use of that unit. Luu alleged that the defendant tenant originally sold take-out but had become a grocery store. The defendant tenant claimed it was not in breach of the purpose of the restrictive covenant, which was to reduce competition, and its West Indian food did not compete with Luu's Asian food grocery store. Luu was successful and obtained an order prohibiting the other tenant from carrying on the business of a grocery store on the basis that Luu's covenant protected the use of a "grocery store" not a "grocery store serving a designated ethnic community."

F. *Jorobin Investments Ltd. v. Lukosius* (2003), 13 R.B.R. (4th) 251 (Ont. S.C.J.) shows the power of a broadly worded restrictive covenant. The tenant, Midas Muffler Franchise, obtained an interim injunction restraining the landlord from leasing an adjacent unit in the strip mall to a Sam's Auto Centre. Sam's Auto Centre lease contained a clause that its unit was to be used only for "automotive repairs (not to conflict with the uses carried out by other tenants at their property)". The Midas Muffler lease contained a use clause for "selling, installing and/or servicing automotive parts and accessories" and a restrictive covenant by which the landlord covenanted not to permit the operation of a business "similar to the aforesaid business ..." The Court held that the lease to Sam's Auto Centre violated the Midas Muffler restrictive covenant and the injunction was granted. Though Midas Muffler was essentially a muffler repair shop, its use clause recognized that it provided other automotive repairs and services and allowed for the evolution into other areas of related automotive businesses. The overall thrust of its restrictive covenant was to preserve its competitive advantage in the strip mall.

G. In *County Stop Donuts Ltd. v. Great West Life Assurance Co.*, [1996] O.J. No. 3521 (S.J. Gen. Div.), the plaintiff successfully obtained a declaration that its restrictive covenant, which gave it the exclusive right to sell donuts and submarine sandwiches, precluded the use of part of a neighbouring grocery store as a Subway Submarine sandwich counter. The plaintiff also sought rescission of the lease and return of the capital invested in renovating the premises plus damages. The Court found no misrepresentation or fundamental breach that would justify rescission. In addition, by seeking of an injunction to require the landlord to remedy the breach, the plaintiff had taken the very opposite route from acceptance of the fundamental breach.

H. The result was different in *Prince Business Inc. v. Vancouver Trademark Inc.* (1994), 99 B.C.L.R. (2d) 26 (C.A.), where a breach of a restrictive covenant was found to be fundamental to the lease, in part because the breach was incapable of remedy since the landlord had neglected to obtain covenants from other tenants necessary to make the plaintiff's restrictive covenant enforceable. By contrast, in *County Stop Donuts*, the breach had been remedied, and after only 11 months of a 10 year term the tenant was still in possession and able to enjoy the rights for which it contracted, and so did not deprive the tenant of the benefits of its bargain and was compensable in damages.

I. In *Hon's Wun-Tun House (Robson) Ltd. v. The Owners, Strata Plan VAS2846*, 2006 BCCA 456, a restrictive covenant on title prohibited any other mall unit from being used for a "full service Chinese restaurant." Another tenant commenced operating a fast food restaurant. The Court found no breach of the covenant because a fast food, food court type, restaurant was not a "full service Chinese restaurant." The tenant's application for an injunction was dismissed as weak on the merits.

J. *Showmart Management Ltd. v. 853436 Ontario Ltd.*, [1998] O.J. No. 1645 (C.J.) is a case where a restrictive covenant was narrowed by the lease's use clause. The tenant's lease permitted a "delicatessen" and its restrictive covenant prohibited "any restaurant of a similar type and nature to a tenant's permitted use." The tenant had expanded its restaurant menu beyond delicatessen. The Court found the restrictive covenant did not prevent the landlord from leasing to a restaurant, so long as that restaurant's "use" was not similar to a delicatessen. It relied on extrinsic evidence to conclude

that, when entering the lease, the tenant and landlord contemplated a traditional delicatessen. The fact that the lease did not prohibit the tenant from adding variety to its menu does not mean that the expanded use would be protected by its exclusivity clause.

Community of Interests

K. In general, only a party receiving the benefit of the restrictive covenant can seek to enforce it. An exception to this application of the rule of privity of contract is the situation of shopping centres where there is a "community of interest" amongst the tenants. The general principles are as follows:

> Generally speaking, covenants in restraint of trade are void at common law; however, such covenants may be deemed to be lawful if in the mutual interests of the parties concerned, and not otherwise contrary to the public interest; that such covenants may be included in leases, and particularly in shopping centre leases which enure to the benefit of all tenants; that such covenants are mutually and reciprocally enforceable as between landlord and tenant, and as between tenants if it is sufficiently clear from the respective leases that a community of interest is thereby created.
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> *Re Spike et al v. Rocca Group Ltd. et al.* (1979), 107 D.L.R. (3d) 63 (P.E.I.S.C.)

L. Limits on the doctrine were established in *Salmon Arm Pharmacy Ltd. v. R.P. Johnson Construction Ltd.*, [1994] B.C.J. No. 1266 (C.A.). The plaintiff pharmacy had a restrictive covenant against other drug stores. When Safeway opened a drug store in its supermarket, the pharmacy sued the landlord. The landlord claimed indemnity from Safeway for breach of a restrictive covenant in its lease that Safeway would not assign the lease or sublet the leased premises so as to conflict substantially with any other existing exclusive use granted by the lessor. The defendant landlord also alleged that the doctrine of "community of interest" entitled it to indemnity from the third party Safeway. The Court of Appeal held there was no possibility that the landlord could succeed at trial in its third party claim against Safeway and therefore struck it out. The Safeway lease predated the plaintiff's lease and did not contain any restriction on Safeway's use of the premises. The Court held that Safeway had not sublet or assigned any portion of its store but merely granted an employee a license to operate the pharmacy. The landlord argued that the doctrine of "community of interest" created indirect privity of contract, not limited to cases where tenants have given parallel or corresponding restrictive covenant to the landlord. It said the tenants each had made parallel contractual restrictive covenants which were designed for their common advantage. The Court held that, because there was no restriction on Safeway's use of the premises, the issue of "community of interest" could not arise. The landlord did not seek to enforce Safeway's lease against itself. Rather, it sought to enforce its own covenant in the pharmacy's lease against Safeway, which was a stranger to that contract. The doctrine of "community of interest" would only apply to questions as to who may enforce the restrictive covenant against the very tenant who gave that covenant. Thus, considerations of community of interest arise only where:

1. one tenant seeks to enforce a contractual obligation owed by another tenant to the landlord;
2. both tenants have use restrictions in their leases which limit the use to which the tenants can put their premises; and
3. both tenants must have the benefit of restrictive covenants by which the landlord promises not to allow the use of any portion of the shopping centre for a purpose which competes with that of another tenant.

M. When interpreted in this manner, the community of interest doctrine allows one tenant to insist that another tenant live up to its own contractual obligations where each tenant has made parallel commitments designed for their common advantage. If these requirements are not met, the tenant's only recourse is against the landlord for breach of its own restrictive covenant. The courts will not use the "community of interest doctrine to imply a restrictive covenant into the third party's lease."

N. For a similar outcome see *Cadillac Fairview v. Canada Safeway*, *supra*. For a case where community of interest was upheld see *London Drugs v. Truscan*, *supra*.

V. Radius Clauses

A. Radius clauses provide that a tenant will not carry on a competing business within a specified radius or defined area around the premises. Their purpose is to protect the competitive advantage of the landlord's overall development and/or its income from percentage rent. If percentage rent is payable the radius clause will often stipulate that, if the tenant is in breach, the gross revenue of the offending business will be included in the calculation of percentage rent.

B. Because their effect extends even beyond the development in question, radius clauses are considered more of a restraint on trade than other restrictive covenants. Our courts have therefore stipulated their limitations (*Salloum v. Thomas* (1986) 12 Canadian Patent Reporter (3d)):

(1) A contract in restrain of trade is against public policy and is generally unenforceable;

(2) The only exception to the general rule arises where, in reference to the interest of the parties, the covenant is reasonable so as to afford adequate protection to the party seeking protection, and in reference to the public interest, the covenant is no way injurious to the public;

(3) The burden of establishing the restraint is reasonable as between the parties is on the party seeking to rely on the restraint;

(4) To be reasonable, the restraint must be no wider as to geographical area and time of operation than is reasonably necessary to protect the party's interest;

(5) The question is not whether the parties could have made a valid agreement, but whether the agreement actually made was valid.

C. *Vanreal Properties Ltd. v. Erisan Inc.*, [2003] O.J. No. 4701 demonstrates the complex corporate identity issues that can arise in the context of radius clauses. In that case, the lease said:

> The Tenant shall not directly or indirectly own, participate in, lend money to or furnish any financial aid or any other support or assistance of any nature whatsoever to any business, enterprise or undertaking in within the Permitted Radius which is in any manner or degree competitive with the business carried on in the Leaded Premises, except any such business carried on by the Tenant at the Commencement Date. If the Tenant breaches this covenant the Landlord may in addition to all other remedies it may have require that all revenue from any such competing business be determined, reported and added to Gross Revenue and the Landlord shall have all rights with respect to such revenues as they were Gross Revenue.

D. The Court recognized that the tenant was not to escape part of its rental responsibility by dividing its business into different parts (i.e., revenue splitting). The Court held that such a goal was manifestly reasonable by reference to the interest of the parties and the public. However, the Court held that there was no breach of the radius clause as written where the tenant itself had not provided any assistance or support to, or participated in the business of, the neighbouring business, though that neighbouring business and the tenant were both subsidiaries of a parent company.

VI. Conclusion

A. The cases summarized in this paper reveal the importance of the content of use and competition clauses to landlords and tenants. The various remedies provided in the cases have significant impact on the parties. For example, tenants have found themselves enjoined from certain uses of their premises, restrained from ceasing operations, or required to provide vacant possession for unauthorized uses that triggered default clauses. Landlords, on the other hand, were found in fundamental breach, ordered to pay punitive damages for wrongful termination, or caught between the dilemma of one tenant's use clause that conflicted with another's restrictive covenant.

B. Hopefully this consideration of the judicial interpretation of such clauses provides guidance for drafting and advising clients.