New York Law Journal

ALM Properties, Inc.
Page printed from: *New York Law Journal*

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On the Path of Lease Resistance

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New York Law Journal

11-21-2011

If a retail tenant enters into a lease for space within a shopping center and the landlord does not disclose a co-tenant's exclusive use provision or other restrictions affecting the leasable space, what are the potential consequences to the new tenant if its business use infringes upon or violates any such restrictions?

Many leases for space in shopping centers and malls include restrictive covenants and/or exclusive use provisions that prohibit certain uses by other tenants operating within the shopping center. By negotiating for an exclusive use provision or prohibiting certain uses, a retailer can effectively prevent the landlord from renting nearby space to a competitor.

However, these restrictions may not be discovered by a new tenant before the tenant executes its retail lease. In this situation, the new tenant may subsequently find itself entangled in unexpected lawsuits with the landlord and the co-tenants that enjoy the unknown restrictions. If a co-tenant seeks injunctive relief, could it enjoin the restricted use, possibly shutting down the new tenant's store? If the co-tenant seeks monetary relief, could the new tenant be liable for damages that may include lost profits? What can New York law practitioners do to protect their retail clients and minimize the risks posed by potential unknown restrictions and exclusive use provisions?

The Law of Restriction

The general New York law regarding restrictions is well-established. New York law generally favors the free and unencumbered use of real property and disfavors restrictive covenants such as use restrictions. To this end, New York courts have held that covenants that restrict the use of real property are to be strictly construed against those seeking to enforce them and are not to be enlarged or extended by judicial interpretation. Moreover, the burden of enforcing a restrictive covenant rests on the party seeking to enforce it, and that party must establish the restriction by "clear and convincing" evidence. See *Hussein Envtl. Inc. v. Roxborough Apt. Corp.*, No. 114295/2007, 17 Misc.3d 1130A, at *3 (Sup. Ct. N.Y. Cty. 2007).

New York courts have held that a retail tenant is restrained and bound by a restrictive covenant or an exclusive use provision where the tenant had *actual* or *constructive knowledge* of the use restriction or exclusive use provision before entering into its lease. The determination of whether a tenant has actual or constructive notice is generally a fact-intensive exercise for a court. A tenant will have actual notice if it has actually been made aware of the covenant or provisions by the landlord, the co-tenant, or another source.

Significantly, however, a New York appellate court has found that "there is no authority to support [the] contention that [a tenant] [i]s under a duty to inquire of [the landlord] as to the existence of restrictive covenants in the leases of other tenants." *Shoe Town (NY) Inc. v. Independent Properties Company Inc.*, 453 N.Y.S.2d 778 (3d Dept. 1982). In these situations, ignorance of the restriction equates to lack of actual knowledge, and the tenant is not required to seek out the information from the landlord. However, the tenant will typically be deemed to have constructive notice of the restriction if it is contained in a

recorded instrument (such as a recorded lease between the co-tenant and the landlord or a recorded memorandum of lease referencing such restriction). In this case, the tenant's subjective ignorance will *not* prevent the application and enforcement of the restriction against its use.

Courts have not hesitated to grant summary judgment in favor of a defendant/tenant where such tenant affirms that it had no knowledge of the restriction at the time it entered into its lease and the use restriction is not in a recorded instrument. Illustratively, in *Shoe Town*, the plaintiff, who operated a shoe store located in a shopping mall, negotiated for a provision in its lease providing that no other store in the mall be permitted to sell any type of footwear. However, the landlord subsequently entered into a lease with the defendant, who also operated a shoe store.

The Appellate Division, Third Department, affirmed summary judgment on behalf of the defendant/tenant, dismissing the plaintiff's injunction action, because the president of the defendant submitted an affidavit that he had no knowledge of the restriction when he entered into his lease with the landlord and there was no record of a recorded lease. 453 N.Y.S.2d at 778-80. Because the defendant/tenant had no knowledge, actual or constructive, of the plaintiff's use restriction, the plaintiff could not enjoin the defendant's sale of shoes.

Similarly, in *Fox v. Congel*, the plaintiff/tenant, who operated a sporting goods store, negotiated a provision in its lease prohibiting the landlord from renting space in the mall to another tenant whose principal line of business was the sale of sporting goods and related accessories. However, the landlord breached the covenant in the lease and rented space within the same mall to a competing store. In *Fox*, as in *Shoe Town*, the Third Department affirmed summary judgment dismissing the complaint seeking injunctive relief against the defendant/tenant because its principal affirmed that he had no knowledge of the restriction and the plaintiff only offered conclusory allegations to the contrary. *Fox*, 426 N.Y.S.2d at 880.

Even where they have not granted summary judgment, courts have been hesitant to affirmatively bar the use of the defendant/tenant's store because of a use restriction without ample evidence of the tenant's knowledge. See *Blueberries Gourmet Inc. v. Aris Realty Corp.*, 255 A.D.2d 348, 350 (2d Dept. 1998) (denying preliminary injunction because no proof of knowledge by the new tenant); *Hussein Envtl.*, 17 Misc.3d 1130A, at *4 (denying motion for preliminary injunction where there is a factual dispute as to the tenant's knowledge of a use restriction where it submitted an affidavit denying knowledge and the plaintiff submitted an affidavit contending that the new tenant had advance knowledge of the restriction); *LIR Mgmt. Corp. v. Mid-City Assocs.*, 584 N.Y.S.2d 559, 560 (1st Dept. 1992) (affirming preliminary injunction notwithstanding large sums advanced by the tenant because the tenant had "full knowledge of the restrictive covenant").

As noted, only when a plaintiff establishes a defendant/tenant's knowledge of the restriction may it enjoin the violation of the restriction (i.e., prevent the defendant from engaging in the restricted activity). See *LIR Mgmt. Corp.*, 584 N.Y.S.2d at 560. If the plaintiff/tenant cannot establish the defendant/tenant's knowledge of the restriction, the plaintiff may *only* seek monetary damages from the *landlord* under breach of their contract. See *Won's Cards v. Samsondale/Haverstraw Equities, Ltd.*, 165 A.D.2d 157, 162 (3d Dept. 1991) (breach of contract damages available against landlord if the facts support it); *Shoe Town*, 453 N.Y.S.2d at 780 (granting summary judgment for plaintiff against landlord for damages).

Additionally, if the plaintiff/tenant can establish the defendant/tenant's knowledge of the restrictive covenants (authorizing injunctive relief), the plaintiff may not seek monetary damages against the defendant/tenant because there is no contractual privity between those parties. See *Won's Cards*, 165 A.D.2d at 162 (affirming dismissal of breach of contract claim against the tenant because it was not a party to a contract with the aggrieved other tenant). Monetary damages can only be recovered from the landlord who breached its contract with the obligations to the plaintiff/tenant.

Best Practices

In light of the noted risk that a new tenant's use may be enjoined, a New York practitioner representing a prospective retail tenant looking to enter into a new lease for space in an existing shopping center must recommend appropriate diligence prior to the client's entry into the new lease. The diligence should be completed early in the process before the retail client incurs the substantial costs related to negotiating the specific details of the lease, conducting diligence of the site, or actually renovating and preparing the new space.

Because the new tenant will be bound by its constructive knowledge, which could possibly result in an injunction preventing the tenant's intended use, it is essential to check the property records before the lease is executed. The practitioner should order a title report of the shopping center within which the leased premises will be a part. Additionally, if there is knowledge that the landlord owns other commercial property in the immediate area, it would be prudent to include such property in the title search to capture any other restrictions the landlord may have agreed to that could affect the shopping center in which the client is considering renting space.

The practitioner should also consider taking additional steps beyond the title search, particularly for more risk-averse clients. To this end, the prospective tenant could request to review all the existing leases for space within the shopping center or any adjacent commercial property owned by the same landlord. However, it is very unlikely that any landlord will share such leases

with the new tenant, leaving the new tenant to investigate other sources.

Additionally, the practitioner should simply inquire of any known restrictions or exclusives that may affect the new tenant or its space by asking the landlord directly. If the landlord does not object, the practitioner could consider speaking with the co-tenants as well. Any inquiries concerning co-tenants' exclusive use provisions should occur before the lease is executed so that the client avoids expending money and efforts renovating, marketing and generally preparing the new space. It should be noted again that these inquiries are not required by existing case law. However, the direct approach could save money and minimize risk long-term.

By inquiring more than what is legally required, the practitioner may be able to discover an undisclosed restrictive covenant. Although this hypothetical restriction would not have been enforced against the client without the client's prior actual or constructive knowledge, the unknown exclusive use provision could have led to expensive litigation concerning the client's intended use of the property, and potentially delaying the use as intended (i.e., preventing the store from opening) and otherwise negatively affecting the client's business.

The additional inquiries could lead to actual knowledge of the hypothetical restriction, and *the client would then be bound by the previously unknown provision* as a result of its actual knowledge. In this case, the client might have to forego an opportunity it otherwise would have taken. However, by making such additional inquiries before executing the lease, while it may appear as a downside, the client may potentially minimize future risk and costs associated with litigation and potential closing of an opened store. The amount of additional inquiries should be weighed based on a cost/benefit analysis as against the risk-tolerance of the client.

If the client/tenant uncovers certain restrictions and exclusives in advance of finalizing its lease, the practitioner should try to include certain representations by the landlord in the lease confirming that there are only certain exclusive use provisions (if any) that have been disclosed and specified in the lease. The practitioner should try to include a broad indemnification clause so that the landlord will be obligated to pay for the client's legal fees, damages, and costs if the client is subsequently included in any lawsuit related to an undisclosed or misrepresented exclusive use provision. The practitioner could also try to include a liquidated damages provision in the lease, which could cover all damages caused by any interruption to the client's business, including lost profits.

As such, an attorney representing its retail tenant should keep in mind the potential expensive and dead-end-road-ahead for his/her client if the client finds itself in violation of existing restrictions affecting its lease space. By taking some of the effective diligence steps and negotiating certain protective provisions in its lease all as noted above, a retail tenant can substantially reduce its risks associated with the pitfalls of violating any restriction provisions that may be out there.

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