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Interpreting Exclusive-Use Contract Provisions

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Special to the Legal

The recent Pennsylvania Superior Court case of *Eckerd Corporation v. Glen Eagle Retail* illustrates a number of basic real estate principles and as such provides a good refresher on a number of issues for counsel representing either landlords or tenants. Eckerd prevailed in this action, and as of the time of writing of this article, the case has been remanded for determination of damages.

The facts of the case are relatively simple. During the period 1987-1989, landlord Glen Eagle was busy negotiating leases for two key tenants to include in its Glen Eagle Shopping Center: one with Thrift Drug (later Eckerd) and one with Genuardi's. Early on during the Eckerd negotiations, Eckerd indicated to Glen Eagle that it required the exclusive right to operate a pharmacy in the center. Correspondence indicates the Glen Eagle acceded to this request, and negotiations continued after Glen Eagle assured Eckerd that the pending Genuardi's lease prohibited the supermarket from operating a pharmacy.

Discussions on the two leases continued, and in November 1988, Glen Eagle and Genuardi's signed a lease that allowed Genuardi's to operate "any retail use now or hereafter customarily found in full-service supermarkets around the country." There was nothing in the Genuardi's lease prohibiting that tenant from operating a pharmacy.

Eckerd's lease with Glen Eagle was executed a few months later. The Eckerd lease provided in part that: during Eckerd's tenancy, Glen Eagle would not use or occupy or permit the use or occupancy of any part of the center

as a pharmacy, or a store primarily engaged in the sale of health and beauty aides; and Glen Eagle would not enter into any lease permitting others to engage in these activities. The lease also expressly stated that that it was the landlord's intention to grant Eckerd the exclusive right to engage in these activities and that the landlord had not granted "similar rights" to any other parties.

In August 2001, Genuardi's opened a pharmacy. Eckerd unsuccessfully sought to enjoin this operation. Because the Genuardi's lease predated the Eckerd lease, Genuardi's clearly had priority with respect to any use issues, in the absence of any provisions in its lease to the contrary.

At this point, Eckerd appropriately turned its attentions to the landlord, Glen Eagle, asserting breach of that party's obligations under the lease and also breach of a covenant of good faith and fair dealing. Glen Eagle responded with a variety of defenses, although, under the facts, it would seem that it had a very difficult case to make. Nonetheless, Glen Eagle prevailed at the Common Pleas level, obtaining summary judgment against Eckerd.

As an initial matter, Glen Eagle had persuaded the court to begin with the base premise that exclusives, as "restrictive covenants," must be construed strictly against the tenant. Evaluating the lease terms in that light, the court concluded that the language of the Eckerd lease proscribed the landlord only from permitting future tenants to operate competing pharmacies. Moreover, it read the final covenant of the landlord as simply a representation that the landlord had not granted to others similar exclusives, as opposed to a covenant that it had not granted them right to conduct similar permitted activities. In other



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words, the court was persuaded that this final proviso constituted a covenant only that Genuardi's had not itself been given a pharmacy exclusive.

In its appeal before the Superior Court, Eckerd argued that the lower court had allowed the imperative of strict construction to unreasonably restrict its interpretation of the relevant lease provisions. The lower court had in fact interpreted the various individual leasehold provisions on a piecemeal basis, and so narrowly that Glen Eagle was able to essentially shoehorn its actions into a course that, in the lower court's opinion, did not breach the contract.

In so doing, the lower court ignored the most pointed language in the lease, which read "it is the intention of landlord to grant to tenant the exclusive right to operate and conduct within the [shopping center] the aforesaid type of business [a pharmacy] so long as this lease

remains in effect.” In the words of Eckerd’s counsel, “the trial court used strict construction to avoid enforcing the provision, rather than to determine its scope.”

With respect to Genuardi’s, it is clear that Eckerd had no right to require it to cease its pharmacy operation. Genuardi’s was first to sign a lease, and Eckerd had knowledge of its tenancy, if not the actual terms of its lease.

As with other title issues, notice of prior relevant leasehold provisions binds subsequent parties, including co-tenants. Such notice may be obtained through actual knowledge of the lease terms or may be obtained constructively. Constructive notice may be afforded by the fact of the physical visible presence of the tenant or through a recorded memorandum of lease. As noted in the federal district court case of *J.C. Penney Company v. Giant Eagle Inc.*, a memorandum need not even specifically state that an exclusive exists in order to be considered notice of such a provision. (Notwithstanding this, though, it is still considered better practice by many to expressly include such provisions in record documents in order to forestall unnecessary disputes.)

The Superior Court found no need to address the issue — raised by Glen Eagle — of whether the language of the Eckerd lease prohibited Glen Eagle from entering into any lease allowing a pharmacy, or was limited in application to only prospective leases. This is because Glen Eagle had also covenanted specifically not to even allow the use of space in the center as a pharmacy. The fact that neither Eckerd nor the landlord, at that point, had any power to enforce this provision was of course not relevant — what mattered was that the landlord made a promise, which it breached.

The Superior Court cited the 1980 Pennsylvania Supreme Court case of *Teodori v. Werner* as standing for two important principals applicable to the instant case: first, that Pennsylvania courts acknowledge the substantial importance of a landlord’s non-compete and exclusivity provisions, and second, that the standard rules governing construction and interpretation of contracts apply in the context of commercial lease transactions. Although generally approving Glen Eagle’s position that restrictions on the use of land should be interpreted narrowly, the Superior Court nonetheless held that the exclusives in the Eckerd lease were expressly stated and their violation clear. Moreover, the court held, the course of the negotiations made clear the intentions of the

parties which, under contract principles, is of primary importance.

FOOD FOR THOUGHT

It is difficult to fault Eckerd for its actions leading up to this case, as the lease provisions it negotiated were reasonably clear, and it obtained a straightforward representation that reasonably led it to believe that Genuardi’s could not operate a pharmacy. The Superior Court’s decision bears this out, although it is true that the lower court’s decision provides an illustration of how the language in a contract can be turned on its head in a skillful argument, and so reaffirms the need to take great care in drafting provisions of such importance. While the Superior Court found it unnecessary to determine whether a provision in which the landlord promised not “to lease” to competing tenants referred to all leases or only prospective leases, the lower court was persuaded that it meant the latter — consider this the next time you read such a provision.

Glen Eagle obviously made the big mistake, losing track of the fact that it was simultaneously offering two prospective tenants entirely inconsistent transactions. This of course argues most simply for good lease management practices to avoid such mistakes.

In addition, some landlords try to build into their leases further protection against their own mistakes, by including boilerplate to the effect that, “notwithstanding anything herein to the contrary, any rights of tenant hereunder are subject to any expansion rights, options or other rights previously granted by landlord to other tenants at the center.” This, of course, should give rise to questions in prospective tenants’ minds as to the scope of this carveout, but it may be that smaller tenants occasionally accept such a provision without question.

The case also gives rise to another interesting question, from both parties’ perspective. Under the principles of *Teodori* and other leasing cases, a tenant presented with such a material breach is entitled to either terminate its lease or to obtain damages, normally the diminution of value of the leasehold interest.

Obviously, Eckerd does not want to terminate a valuable lease in an improved location. Under traditional thinking, however, Eckerd’s monetary damages are more akin to consequential damages, albeit predictably related (in nature, at least) to the breach. How will the court in this case determine the actual damage to Eckerd of losing some portion of its sales traffic to Genuardi’s? Is this something that the parties

want to leave to a court and “expert testimony”? Perhaps the boilerplate for all exclusives should contain a liquidated damages provision, in acknowledgement of the difficulty of calculating the actual damages occurring as a result of a violation by landlord.

Finally, what is also interesting (and frightening, in a “there, but for the grace of God, go I” sort of way) is the fact that the Glen Eagle Shopping Center actually changed hands during the period of time between the execution of the two leases and the announcement by Genuardi’s that it was going to include a pharmacy in its store. Though it would have required an extremely sharp set of eyes to spot it, the fact is that the buyer of the center had the opportunity to discover the inconsistency between these leases and thus avoid a headache.

As a lesson to practitioners, it should remind us, when conducting due diligence, to consider not only the leases themselves, but also any interplay and relationships between them. Once a sale has occurred, given the standard documentation most parties would sign in a shopping center sale, it would not be typical for the buyer to have any recourse against the seller later, unless the buyer had specifically identified the issue and sought an indemnity or reformation of one of the leases prior to closing. Any representation respecting breaches by landlord under the leases is often to be limited to landlord’s knowledge and in any event, usually expires at or shortly after closing.

The court in *Eckerd v. Glen Eagle Retail* got it absolutely right. The intent of the parties here was to grant Eckerd an exclusive, even though other landlord representatives, negotiating with Genuardi’s, may have been unaware of that fact. The Superior Court generally declined the invitation to interpret many of the potentially ambiguous lease provisions, but focused instead on the one or two provisions which were most clear on the issue — and concluded that the express language reflected that intent. In so doing, the court reiterated that commercial leases are contracts and should be treated as such, and it also reminded us that Pennsylvania courts recognize the very critical nature of exclusives in the commercial real estate market, something which even the bankruptcy courts have recently begun to appreciate. The case is interesting in illustrating how a tenant, though it failed to achieve its primary objective — an exclusive right to operate a pharmacy — was still able to hold the landlord accountable for its failure to deliver that promised benefit. •