

Immovable Object Meets Irresistible Force

~ a discussion on merchandise mix, uses and exclusives ~

ICSC+CANADIAN LAW CONFERENCE

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10:45am - 12:00pm

Location: MTCC North Building, Room 203AB

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Overview

When they work together, landlords and tenants create vibrant shopping experiences that promote a maximum return on investment for both parties. While their interests align on this objective, achieving it often involves addressing matters where their respective interests compete. The mix of uses in a shopping centre is one such matter. A landlord seeks to create an attractive mosaic of synergetic uses. It also wants to maintain sufficient flexibility to be able to allow the shopping centre to evolve as the market evolves, and be able to seize new opportunities that may arise in the future. Accordingly, a prudent landlord will negotiate appropriate boundaries on each tenants' use. This typically takes the form of a "permitted use" clause, as well as a list of expressly "prohibited uses". A tenant, for its part, seeks comfort that it can carry on its business in the manner that it forecasts will be most profitable, and without undue competition from other tenants. Tenants seek broadly-worded, permissive "use clauses", and attempt to limit competition in the shopping centre through rights of exclusivity. Depending on the nature of the development, tenants may also seek "co-tenancy" rights, which underscore how a tenant is part of a greater whole.

What Happened Historically?

When the enterprise that came to be known as a "shopping centre" or "shopping mall" first started appearing in Canada in large numbers in the 1960s and 1970s, the major anchor tenants that committed to join the mall (i.e., tenants like HBC, Sears, Woolco, Eatons, Simpsons, etc.) were critical to obtaining the financial commitments required to proceed with the development. Typically, these major anchor tenants were sophisticated and experienced retailers that understood their demographics and market. Given the investment they were making in these developments, major anchor tenants in new centres were positioned more as informal partners in the development, inasmuch as their participation and approval over the merchandising mix and any substantial alterations or redevelopments was secured in their leases. These anchors were often not subject to much, if any, restriction on how they could use their premises, and at the same time, they had substantial control over to whom the landlord could lease other areas in the centre, and for what purpose. Sometimes, the leases to these major anchors contained a list of uses which the landlord was prohibited from allowing in the centre, and in some cases, a requirement that the landlord

obtain the tenant's approval prior to leasing to any other tenant or making any alteration to the centre whatsoever.

Initially, smaller tenants, while limited somewhat by their leases as to the purposes for which they could use their premises, were not typically provided with much or any protection from competition in the centre. Progress has been made for smaller tenants on this front as they grew in clout and sophistication. While some protection against competition for smaller tenants has become not uncommon to see, their leases continue to constrain their uses and don't provide much room for evolution or adjustment.

Over time, the tools used by lease drafters to accommodate the parties' respective rights of control coalesced into an informal collection of industry-standard lease clauses. What follows are a few definitions of common industry terminology on this subject:

- **Permitted Use** – this is the description which limits the type of business that a tenant may operate from its premises. These clauses are used by the landlord to control the merchandise mix in the shopping centre, and to regulate compliance with exclusive use rights that the landlord has granted to other tenants.
- **Principal Use** – this term is often used to describe the predominant part of the tenant's "permitted use". In some cases, the term "primary use" is used instead.
- **Ancillary Use** – this term is often used to describe a part, or parts, of the tenant's "permitted use" that are subordinate to the tenant's "principal use". In some cases, the terms "incidental use" or "auxiliary use" are used instead.
- **Prohibited Uses** – these are the uses which the tenant is expressly prohibited from engaging in. These prohibitions are designed to protect the landlord's investment in the shopping centre. They are specifically used to prevent the tenant from using the leased premises in a manner that is a nuisance to other tenants, reduces the overall value of the property, or does not align with the landlord's desired image for the shopping centre. Some

examples of prohibited uses are: flea markets, second hand goods stores, or adult entertainment facilities. Some landlords also include those uses protected by exclusives in favour of other tenants.

- **Exclusive Use** – this is the use for which the tenant is provided some degree of protection from competition in the centre. This protection is effected by the landlord’s commitment not to lease, or permit to be used, any premises within all, or a defined area, of the shopping centre for some part of the tenant’s permitted use. These commitments are often subject to conditions, carve-outs and exceptions.
- **Co-Tenancy** – this is a clause which makes the tenant’s performance of some (or all) of its obligations under the lease conditional on circumstances or events relating to other tenants in the shopping centre. For example, a tenant may tie its obligation to continuously operate to the active operation of certain anchor tenants and/or the operation of a certain amount of non-anchor tenants. Some co-tenancy clauses allow the tenant to pay some lesser rent, or even terminate its lease, if certain conditions are not satisfied for a prolonged period of time.

But much has happened since the 1960s and 1970s, and since then, the balance of rights regulating the uses in a shopping centre has changed. It is very rare for a landlord to grant sweeping rights of control over the centre, even to major anchors. Landlords want the freedom to decide on their own how to develop and operate their centres in order to curate an attractive merchandise mix that will be profitable for all parties. Over the years, major anchors have ceded some of their control over merchandise mix. In addition, a new category of mid-range tenant, lying somewhere between a traditional anchor and a small CRU, has grown in prominence. This new tenant class (think Dollarama, Apple Store, Sephora) comprises an ever-increasing footprint in shopping centres, and drives a substantial degree of foot traffic. Their increased clout allows them to negotiate for flexible “permitted uses” and strong “exclusives”, often with significant remedies. These rights, however, tend not to go as far as requiring the tenant’s blanket approval of any new tenants or redevelopment.

Principal vs Ancillary Uses

“Permitted use” clauses often describe a tenant’s use in two components: “principal use” and “ancillary use(s)”. The purpose of this dichotomy, as far as the landlord is concerned, is two-fold. Firstly, the landlord utilizes the concept of a “principal use” to ensure the predominant nature of the tenant’s business is preserved throughout the lease term. The landlord is attracted to the tenant’s business as it exists at the time of deal-making, and wants to ensure that the tenant will be required to carry on that business, without material change as to the type or nature of its offering. Secondly, if any exclusive will be provided to offer the tenant some protection from competition in the shopping centre, it will typically only extend to the tenant’s principal use.

However, in many cases, a tenant’s business cannot be circumscribed entirely in the generic labels often used to set out a “principal use”. Furthermore, many tenants want the ability to offer goods and/or services that extend beyond the traditional boundaries of their “principal use” classification. These considerations give rise to “ancillary uses”, which set out a list of uses which are permitted in the premises, but which may not rise in predominance so as to change the core nature of the tenant’s business. It is not uncommon for “ancillary uses” to be limited in terms of floor area or gross revenue.

Some sample uses clauses of this nature are:

- The Tenant shall use the Premises for no purpose other than: principally, an all-day breakfast restaurant, and on an ancillary basis, the sale of specialty coffees.
- The Tenant shall use the Premises only for the primary purpose of a health and fitness club, and on an incidental basis, as a juice bar and for the sale of related clothing.
- The Tenant shall use the Premises primarily as a drug store, and on an auxiliary basis, as a post office, and for no other purpose.

In the first example, a landlord would rely on the division between primary and ancillary, to ensure that the tenant does not, over time, change the nature of its business from a breakfast restaurant to a specialty coffee shop. In the second example, the dichotomy is used to ensure the tenant continues to operate a fitness centre, and does not evolve its business into that of a smoothie vendor and/or clothier. In the third example, the landlord is interested in preserving the use of the premises as a drug store, and it not changing into a postage depot.

Some tenants take issue with the dichotomy of principal vs ancillary. Their issue arises on two levels. Firstly, some tenants see certain aspects of their business, while not predominant, as critical to their operation. These tenants often reject such uses as being relegated to a subordinate status in the lease. Some tenants have concerns about the implications of such status on the tenant's ability to strike the balance between the various uses it carries on. For example, a cinema's primary use may appear to be that of selling movie tickets and projecting films, but their other offerings, including and especially the sale of popcorn, is anything but "incidental" or "auxiliary" as far as the tenant is concerned. Secondly, tenants need the flexibility to be able to develop their business in an ever-changing retail environment. A tenant that signs-on for a term of 10 or more years, may need the ability to adjust the proportions of its current offering, bring in new offerings, or remove some altogether. This latter aspect highlights a main source of tension on this issue between the interests of landlords and tenants. It is a matter of control. Landlords need to curate and control the merchandise mix of their centres, and that means keeping tenants within a defined scope of permitted use(s). Tenants need to control their business, and that may include the need to adjust their offering over time.

The Evolving Retail Landscape

Times change. Landlord and tenants need to evolve to keep up. Current trends are veering shopping centres away from the traditional model grounded in one or two major anchors, and towards a model premised on a compliment of large national brands and mixed uses. The footprint of these large national tenants may not be material on an individual level, but many punch above their weight in that respect when it comes to generating foot traffic in the centre.

Other recent developments include the success of tenants that offer a broad array of merchandise, without any clear core merchandise type. This can create challenges for landlords, as tenants like this are difficult to slot into the “principal use”/“ancillary use” regime. Prohibited use lists are also evolving to keep up with retail trends. With the sharing economy and cannabis operators entering the Canadian retail market, some uses which were traditionally excluded from shopping malls are escaping that shunned position. In addition, more landlords are looking to alternative uses to backfill challenging or awkward space (such as basement levels or third floors of old anchor space). Many of these alternative uses, such as automotive, educational, medical and life science would have been considered inappropriate in the mall environment in the past, but are now often viewed as beneficial to the mall and as traffic and footfall drivers.

Changing merchandising mixes in shopping centres is a concern for tenants as well, as they signed-up to be part of a community of tenants with a particular profile. Some tenants may not have done the deal had they known that the landlord would make significant changes to the types of uses at the centre. Tenants may consider advocating for co-tenancy clauses that will condition their rental or operating obligation on the landlord preserving critical components of the mall.

The Covid-19 pandemic caused no shortage of change in the retail sector. Those tenants that were able to pivot to more online shopping options, did so. Many landlords facilitated in-store/curbside pick-up in support of those efforts. Online retail giants gained even more market share while Covid shutdowns were in place. The reduced dependency of retailers on “brick and mortar” stores is prompting landlords to consider their redevelopment possibilities. Many landlords are considering “de-malling”, which may include increased density and mixed-uses. These can be intriguing options, especially because adding residential or office uses can lead to higher foot traffic in an existing shopping centre. Tenants will have their eye on construction, since the landlord’s redevelopment may interfere with the tenants signage, access and visibility.

It is an interesting time to be in the shopping centre industry. As our world changes, so does where and how we spend our retail dollars. Players in the industry will need to adapt to the changing merchandising mix.