Restrictive user covenants and tenant exclusivity clauses in leases – a reminder

Despite the changes to the application of competition law to land agreements, which came into force two years ago, some tenants still endeavour to negotiate terms into leases or heads of terms which aim to restrict a landlord's freedom to let other units in its building. This restriction might be framed by reference to a type of tenant (for instance, the landlord might promise not to let any other units in its shopping centre to a mobile phone company) or by reference to a number of named companies (usually competitors of the tenant in question). Should a landlord agree to include such a clause in a new lease? Is it a problem if you encounter one in an existing lease?

Background

As set out in more detail in our legal briefing from May 2011 (click here to read it), on 6 April 2011 the exclusion from the Competition Act 1998, which had previously benefitted land agreements, was removed in respect of both past and future transactions. Parties to commercial leases (as well as most other real estate agreements, such as development agreements and sale and purchase agreements) now need to think about whether any proposed restriction breaches the Chapter I prohibition of the Competition Act.

Consequences of breach

If a restriction is found to be anti-competitive, the risks include:

- the offending clause (or possibly the whole agreement if the Court decides that the clause cannot be severed) being deemed to be unenforceable;
- investigation by the Office of Fair Trading (OFT), with potential consequences including fines of up to 10% of each party's worldwide turnover; and/or
- exposure to private action by a third party arguing that its business was damaged by the infringement (for example a retail tenant might argue that its sales figures have suffered as a result of having to lease premises in a less desirable location, or not being able to find premises in the relevant area at all).

Analysing the impact of the restriction

In its guidance on the subject issued in March 2011 (click here to read it), the OFT explained that not all such restrictive or exclusivity clauses will be deemed to be anti-competitive. For example, it indicated that exclusivity in favour of anchor tenants and provisions designed to achieve an appropriate tenant mix will often be capable of justification and therefore not result in a breach of the Chapter I prohibition, subject to certain provisos explained in our earlier briefing. But what if the tenant is not an anchor tenant and the restriction cannot be justified on the basis of tenant mix? In such circumstances, it will often be necessary to consider whether the restriction is likely to have an appreciable effect on competition in the relevant market (which can be the case even in small or local markets) and, if so, whether it can nonetheless be justified on other economic/consumer benefit grounds.

As a general rule, a restriction on the use of land is more likely to impact on competition where the relevant market has a narrow geographic scope. The relevant geographic market for a large supermarket might be a fairly wide area because people may be prepared to drive for 10-15 minutes to access their preferred shop. By contrast, the size of the geographic market for a coffee shop might be only a 5 minute walk. In terms of products/services offered, the key issue is what other products might be substitutable for those provided by the tenant. Taking the example of a coffee shop, you might be able to regard other providers of beverages within the vicinity, such as tea shops and sandwich bars, as forming part of the relevant market.

You then need to consider the extent to which the tenant with the benefit of the restriction is likely to face genuine competition within the relevant geographic market. Ideally, it should be possible to point to the existence of several directly competing businesses. Where this is not the case, it may still be possible to conclude that the restriction does not have an appreciable effect – because, for example, businesses looking to compete with the tenant would nonetheless be able to find suitable premises belonging to other landlords within the relevant geographic market. However, where there are no such alternative premises (and few existing competitors of the tenant), the restriction may be more problematic. This can be particularly relevant with retailers such as supermarkets and petrol stations, where there are limited prime locations with the necessary planning consents.

Even if the impact of the restriction on competition appears to be appreciable, it may still be possible to argue that it justifies an exemption on economic/consumer benefit grounds and therefore does not result in a breach of the Chapter I prohibition. For example, as noted above, anchor tenant exclusivity is considered capable of exemption, at least for a limited period of time, where it can be shown that the overall benefits (such as helping to secure a high profile tenant whose presence will help to attract large numbers of consumers to a shopping centre) may be expected to outweigh any anti-competitive effect. However, much will depend on the specific circumstances of each case.

Assessing the risks

In terms of assessing the risks, it is worth noting that the OFT has indicated that it would be more likely to investigate (and potentially subsequently to impose fines) where the relevant provision shuts out competitors or dampens competition and where either:

- one of the parties has a high market share (30% or more); or
- the provision in question is widely used in the market (such that it may have a cumulative effect).

However, even in cases which are unlikely to trigger an investigation by the OFT, the risks of unenforceability and private enforcement action remain.

As regards agreements entered into before 6 April 2011, where a party has used best endeavours to amend or remove an infringing provision from an agreement, and has not sought to enforce it, the OFT may consider this a mitigating factor in determining the appropriate amount of fines (if any). This should be borne in mind if you encounter a potentially infringing provision in an existing lease.

Conclusions

So far as we are aware, there have been no published decisions of the OFT or the courts on these issues since the law was changed in 2011; as a result, there is no further guidance yet available other than the somewhat impractical guidance published by the OFT in 2011. However, each time you encounter or consider using a landlord's restrictive user covenant or an exclusivity clause in a lease you need carefully to consider whether it is likely to be anti-competitive and, if so, take specialist advice.

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